TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1964

No. 436

W. PALMER DIXON, ET AL., PETITIONERS,

v.

UNITED STATES.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

PETITION FOR CERTIORARI FILED SEPTEMBER 11, 1964
CERTIORARI GRANTED DECEMBER 14, 1964

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1964

No. 486

W. PALMER DIXON, ET AL., PETITIONERS,

v.

UNITED STATES.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

INDEX

RECORD PRESS, PRINTERS, NEW YORK, N. Y., JANUARY 12, 1965

[fol. A] [File endorsement omitted]

[fol. 1]

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Docket No. 28752

W. PALMER DIXON, JOAN DIXON, EVERETT W. CADY, CLARISSA H. CADY, J. HERBERT HIGGINS, MARION BLAIR HIGGINS, STEPHEN A. KOSHLAND, CAROL F. KOSHLAND, HENRY A. LOEB, JOHN L. LOEB, CARL M. LOEB, JR., and MARGARET L. KEMPNER, as Executors of the Last Will and Testament of CARL M. LOEB, SR., Deceased, HENRY A. LOEB, JOHN L. LOEB, CARL M. LOEB, JR. and ALAN H. KEMPNER, as Executors of the Last Will and Testament of ADELINE M. LOEB, Deceased, JOHN L. LOEB, FRANCES L. LOEB, HENRY A. LOEB, LOUISE S. LOEB, CLIFFORD W. MICHEL, BARBARA R. MICHEL, MARK J. MILLARD, CLAIRE MILLARD, HENRY PARISH, 2nd, DOROTHY PARISH, HUBERT R. A. SIMON, SAMUEL L. STEDMAN and GERDA C. STEDMAN, Plaintiffs-Appellants,

HELEN J. GERNON and HELENE G. HIRSON, as Executrices of the Last Will and Testament of FRANK E. GERNON, Deceased, HELEN J. GERNON, Plaintiffs,

against

THE UNITED STATES OF AMERICA, Defendant-Appellee.

APPENDIX TO APPELLANTS' BRIEF—Filed March 30, 1964

STATEMENT UNDER RULE 15(b)

This action was commenced on May 27, 1960, by the filing of a complaint in the United States District Court, Southern District of New York. Plaintiffs seek the recovery of income taxes illegally and erroneously assessed and collected from them. The defendant's answer was filed on September 1, 1960.

[fol. 2] On June 11, 1963, defendant filed a notice of motion for summary judgment. Thereafter, and on August 29, 1963, plaintiffs filed a cross-notice of motion for summary judgment. Both motions were heard before the Honorable Richard H. Levet.

Judge Levet filed his opinion on November 1, 1963, granting defendant's motion for summary judgment. Judgment was filed on November 14, 1963, granting defendant's motion for summary judgment; denying plaintiffs' cross-motion for summary judgment; and dismissing the amended complaint with prejudice.

The appeal was taken on January 7, 1964, with the filing of a notice of appeal.

[fol. 3] IN UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

JUDGMENT—November 14, 1963

This cause came on to be heard on defendant's motion for summary judgment and plaintiffs' cross-motion for summary judgment, as authorized by Rule 56 of the Federal Rules of Civil Procedure, and on plaintiffs' motion for leave to amend their complaint, and the Court having filed an order on October 15, 1963 granting the motion for leave to amend, and it appearing to the Court that with respect to the defendant's motion for summary judgment, there is no genuine issue as to any material fact, and the Court having heard the arguments of counsel, and having filed its opinion herein on November 1, 1963, granting the motion of the defendant for summary judgment and denying plaintiffs' cross-motion for summary judgment, it is

Ordered and adjudged, that plaintiffs may file an amended complaint in the form attached hereto; and it is

Further ordered and adjudged, that defendant's motion for summary judgment be, and the same hereby is, in all respects granted; and it is

Further ordered and adjudged, that plaintiffs' cross-motion for summary judgment be, and the same hereby is, in all respects denied; and it is

Further ordered and adjudged, that the amended complaint of the plaintiffs be, and the same hereby is, dismissed with prejudice; and it is

[fol. 4] Further ordered and adjudged, that the defendant recover from the plaintiffs the sum of $20.00 costs as taxed by the Clerk of the Court.

Dated: New York, N. Y., November 14th, 1963.

Richard H. Levet, United States District Judge.

IN UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

NOTICE OF APPEAL—Filed January 7, 1964

Notice is hereby given that W. Palmer Dixon, Joan Dixon, Everett W. Cady, Clarissa H. Cady, J. Herbert Higgins, Marion Blair Higgins, Stephen A. Koshland, Carol F. Koshland, Henry A. Loeb, John L. Loeb, Carl M. Loeb, Jr., and Margaret L. Kempner, as Executors of the Last Will and Testament of Carl M. Loeb, Sr., Deceased, Henry A. Loeb, John L. Loeb, Carl M. Loeb, Jr. and Alan H. Kempner, as Executors of the Last Will and Testament of Adeline M. Loeb, Deceased, John L. Loeb, Frances L. Loeb, Henry A. Loeb, Louise S. Loeb, Clifford W. Michel, Barbara R. Michel, Mark J. Millard, Claire Millard, Henry Parish, 2nd, Dorothy Parish, Hubert R. A. Simon, Samuel L. Stedman and Gerda C. Stedman, plaintiffs above-named, hereby appeal to the Court of [fol. 5] Appeals for the Second Circuit from that part of the final judgment entered in this action on the 14th day of November, 1963, which granted defendant's motion for summary judgment, from that part of the said final judgment which dismissed with prejudice the plaintiffs'

amended complaint, and from that part of the said final judgment which denied plaintiffs' cross-motion for summary judgment.

Dated: New York, New York, January 6, 1964.

Stroock & Stroock & Lavan, By: Bernard E. Brandes, A Member of the Firm, Attorneys for Appellants, Office & P. O. Address, 61 Broadway, New York 6, New York, HAnover 5-5200.

To: Robert M. Morgenthau, United States Attorney for the Southern District of New York, Attorney for Respondent, United States Court House, Foley Square, New York, N. Y.

[fol. 6] IN UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

OPINION—November 1, 1963

LEVET, D. J.:

These are cross motions for summary judgment in an action for refund of federal income taxes paid by the plaintiffs for the taxable year 1952 in the sum of $369,329.65 plus interest. Jurisdiction is based upon 28 USC § 1346(a). The parties agree, except for one fact, which will be dealt with later, that there are no issues as to any material facts.

The facts surrounding this claim for refund are as follows.

During the year 1952, the plaintiffs were partners in the investment firm of Carl M. Loeb Rhoades & Co. (hereinafter "partnership"), a member of the New York and American Stock Exchanges. The principal sources of income of the partnership are from commissions earned on sales of customers' securities, the underwriting and selling of securities and from trading and investing on its own account.

During 1952, the partnership acquired 33 short-term non-interest bearing notes, commonly known as commercial paper. All of the notes were issued at a discount which

ranged from $2\frac{3}{8}$ to $3\frac{3}{4}\%$ on the face value of the notes. The notes were purchased either directly from the issuing obligor corporation or through agents or dealers on the original date of issue. The notes had maturity dates between 190 and 272 days from the date of issue. All of these notes were either sold subsequent to six months after their purchase or were retained, unmatured, at the close of the taxable year 1952.

Plaintiffs reported the distributive share of the profit realized from the sale by the partnership of 20 of the notes during the year 1952 as long-term capital gain. The Internal Revenue Service disallowed capital gain treatment and computed the discount earned per day for each note by [fol. 7] dividing the number of days between issuance and maturity into the total discount. The earned discount per day, multiplied by the number of days the notes were held during 1952, either before sale or as of December 31, was considered as "discount earned." The Internal Revenue Service treated the amount of "discount earned" as ordinary income. Deficiencies were assessed against the plaintiffs. The deficiencies were paid, a claim for refund was duly filed, and this action was thereafter commenced.

The parties differ as to the treatment which should be accorded to the original issue discounts. The plaintiffs claim that the amounts so realized are long-term capital gains, while the Internal Revenue Service held them to be interest, therefore, ordinary income. In addition, the plaintiffs urge the Commissioner of Internal Revenue's prior acquiescence in 1944 in the case of Commissioner v. Caulkins, 144 F. 2d 482 (6 Cir. 1944), affirming 1 T. C. 656 (1943), estops the Internal Revenue Service from now claiming that original issue discounts should be treated as interest since they relied on the Caulkins' acquiescence when they purchased the securities in 1952.

Thus, the issue is squarely before the court: Aside from any consideration of reliance or estoppel, when short-term non-interest bearing notes are purchased at a discount, is the amount of such discount when realized in the nature of interest or a capital gain?

Discussion

A. Statutes Involved

There are two sections of the Internal Revenue Code of 1939 which must be considered in determining this action. They are Sections 22 and 117(a)(1). Section 22 provides:

"§ 22. Gross income

"(a) General definition. 'Gross income' includes gains, profits, and income derived from salaries, wages, [fol. 8] or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *"

Section 117(a)(1) provides:

"§ 117. Capital gains and losses

"(a) Definitions. As used in this chapter—

"(1) Capital assets. The term 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

"(A) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

"(B) property, used in his trade or business, of a character which is subject to the allowance for de-

preciation provided in section 23(l), or real property used in his trade or business;

"(C) * * *

[fol. 9] "(D) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest [sic] at a fixed maturity date not exceeding one year from the date of issue."

B. Does the 1939 Code Allow Original Issue Discounts to Be Treated as Capital Gains?

The plaintiffs rely heavily upon the case of George Peck Caulkins, supra. The Caulkins case involved a taxpayer who paid $15,043.33 over a ten-year period for an accumulated installment certificate which returned him $20,000 at the end of the ten years when the certificate was redeemed. The Tax Court and the Circuit Court of Appeals for the Sixth Circuit held that the difference between the amount paid and the amount received by the taxpayer upon redemption was a long-term capital gain. This result was achieved primarily through a peculiar application of Section 117 (f), which provided:

"(f) Retirement of bonds, etc. For the purposes of this chapter, amounts, received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor."

The two courts were of the opinion that $4,956.67 increment received by the taxpayer was a capital gain because Section 117(f) makes the amounts received by the holder on retirement of a certificate or other evidence of indebtedness capital gains. Therefore, on the basis of the Caulkins

[fol. 10] case, the plaintiffs urge that the increment as a result of an original issue discount on a note sold before maturity would result in a capital gain and not ordinary income.

C. The Caulkins Case Was Wrongly Decided.

It is clear that the Courts in the Caulkins case wrongly interpreted the purpose and scope of Section 117(f). The situation which gave rise to the enactment of Section 117(f) is illustrated by the case of Fairbanks v. United States, 306 U. S. 436 (1939). There, the taxpayer acquired bonds at less than par value. The court held that the increment received upon the retirement of the bonds could not be considered as capital gains because the redemption of the bonds was not a "sale or exchange thereof" and the statute defined a capital gain as meaning "taxable gain from the sale or exchange of capital assets". Following the Fairbanks case Section 117(f) was enacted.

It seems plain that Section 117(f) was not designed to accomplish any other purpose but to reverse the type of result achieved in the Fairbanks case. Nowhere in the text of Section 117(f) or in its legislative history is there any indication that if, upon retirement of such bonds, the increment a taxpayer receives would be converted into capital assets or treated as capital gains.

The literal language of Section 117(f) if applied to facts identical to those in the Caulkins case, supra, yields only one conclusion, the increment should be treated as ordinary income. The operative words of Section 117(f) are: "Amounts received by the holder upon retirement * * * shall be considered as amounts in exchange therefor". In a Caulkins-type fact situation, we have a combination of both a capital asset (the notes or other evidence of indebtedness) and the interest on other earnings from that asset. The courts in Caulkins failed to realize that the gain realized from the deemed sale of a capital asset which has appreciated in value is capital gain, whereas, gain realized by income from the capital asset is ordinary income. The [fol. 11] court, in other words, considered both the capital asset and the increment by way of interest or discount to-

gether and considered the combined amount as a capital gain.

The rationale of the Caulkins case has been repudiated in recent years by other courts which had cases similar to Caulkins. See Commissioner v. Morgan, 272 F. 2d 936 (9 Cir. 1959); Rosen v. United States, 288 F. 2d 658 (3 Cir. 1961); United States v. Harrison, 304 F. 2d 835 (5 Cir. 1962), cert. denied 372 U. S. 934 (1963); Pattiz v. Commissioner, 311 F. 2d 947 (Ct. Cl. 1963); Richard B. Gibbons, 37 T. C. 569 (1961); V. David Leavin, 37 T. C. 766 (1962).

The Plaintiffs' Claim of Reliance Upon The Caulkins Acquiescence

The plaintiffs claim that they relied on the Caulkins case and the acquiescence in Caulkins by the Treasury Department when they entered into these transactions in 1952. Since Caulkins has been repudiated by the Commissioner, the plaintiffs contend that to apply this change of position to them would cause them substantial injury.

The law is clear that the Commissioner of Internal Revenue can retroactively correct a mistake of law even where a taxpayer has relied on the previous determination to his detriment. Manhattan General Equipment Co. v. Commissioner, 297 U. S. 129 (1936); Helvering v. Reynolds, 313 U. S. 428 (1941); Automobile Club of Michigan v. Commissioner, 353 U. S. 180 (1957); 10 Mertens, Law of Federal Income Taxation § 60.16 (Zimet Rev. 1958). Therefore, it is clear that plaintiffs' alleged reliance, even if proved, does not estop the Commissioner from applying the correct legal principles in determining the income of the partnership. Therefore, we deem it unnecessary to pass upon this claim of reliance.

[fol. 12] Assuming, arguendo, that the law would allow the claim of reliance, this court cannot agree with the plaintiffs that they have any ground to base their reliance upon the Caulkins decision and the acquiescence by the Commissioner. A thorough examination of the prior Treasury Department rulings demonstrates that the result reached in Caulkins was an exception to the general policy of the

Internal Revenue Service to treat amounts received by original issue discount as income. Also, the prior rulings demonstrate that Caulkins is distinguishable from the present claim on the law and on its facts.

In 1940, G. C. M. 21890, 1940-1 Cum. Bull. 85 was issued. There, the Commissioner held that the amount of an original issue discount upon a state obligation was in the nature of deferred interest, therefore, non-taxable income to the taxpayer under Section 22(b)(4) of the Revenue Act of 1938, which provided for the exclusion from gross income and exempted from taxation interest upon state obligations.

In 1941, I. T. 3486, 1941-2 Cum. Bull. 76 was published. It provided that since the Public Debt Act of 1941 provided that the interest upon, and gain from sale or other disposition of, United States Treasury Bills issued on or after March 1, 1941 are no longer tax exempt, the amount of discount "* * * is includible in gross income as interest * * *"

After Caulkins was affirmed by the Sixth Circuit, the Treasury Department acquiesced in its result. (See list of acquiescences in 1944 Cum. Bull.)

In 1953, the Commissioner published Rev. Rul. 119, 1953-2 Cum. Bull. 95. Rev. Ruling 119 provided:

> "What included in gross income
>
> "The discount at which a 'Twelve Year Dollar Savings Bond' of the State of Israel is originally issued constitutes interest which is taxable as ordinary income [fol. 13] under section 22(a) of the Internal Revenue Code when realized upon redemption; it does not represent an amount received upon retirement of the bond within the meaning of section 117(f) of the Code.
>
> * * * * * * *
>
> "Since about 1920, discount realized on retirement of State and municipal obligations in the hands of the original purchaser has been treated by the Bureau as interest, the theory being that the discount is an amount paid in lieu of interest. * * * The position taken by the Bureau * * * has been consistently maintained with regard to characterizing discount as interest and

treating the excess over discount (and ordinary interest, if any) realized upon retirement as taxable income. However, after the enactment of section 117(f) of the Internal Revenue Code, the excess over discount has been consistently taxed as capital gain rather than ordinary gain. (See G. C.M. 21890, C.B. 1940—1,85) Therefore, only the excess of the amount realized from a State or municipal bond, less discount from the date of acquisition, and ordinary interest, if any, over the cost or other basis of the bond is the amount received upon retirement taxable as capital gain under section 117(f) of the Code.

* * * * * * *

"In the case of Commissioner v. George Peck Caulkins, 144 Fed. (2d) 482, affirming Tax Court decision, 1 T.C. 656, acquiescence, C.B. 1944, 5, the Court held that the excess of the amount received by the taxpayer, pursuant to a contract with Investors Syndicate over the aggregate payments made by him for an Accumulative Installment Certificate, constituted capital gain and stated that the certificate in question '"was an [fol. 14] evidence of indebtedness" similar to a bond or debenture and hence falls within the statutory group governed by section 117(f).' This decision should be limited precisely to what was there decided under the particular facts of that case. It would be inappropriate to apply the decision to any other case unless the facts and circumstances conform to those stated in the published decision of the Tax Court in the Caulkins case."

In 1955, Revenue Ruling 55-136, 1955-1 Cum. Bull. 213 was published. It provided:

"Section 117(f) of the Internal Revenue Code of 1939 applies only to amounts received by reason of redemption of bonds. It does not apply to the amount of interest (whether paid in the form of discount or not) which is received by reason of holding the bond. Such interest-equivalent payments are taxable as ordinary income under section 22(a) of the Code.

* * * * * * *

"It has been the policy of the Internal Revenue Service to restrict the application of the Caulkins case to cases involving the identical facts. This position has been reconsidered in the light of Revenue Ruling 119, supra, i.e., that the amount received upon the redemption of a bond which represents original or initial discount constitutes interest which is taxable as ordinary income. There is no logical basis in fact or in law to distinguish the discount element in the Accumulative Installment Certificate involved in the Caulkins case from the original discount element involved ordinarily in the issuance of any bonds."

It is clear that Caulkins was an exception to the rule that amounts received from original issue discounts were treated as ordinary income. In order for the plaintiffs to [fol. 15] rely on Caulkins it is also clear that their claim must fall into the identical exception Caulkins created. Caulkins involved a peculiar application of Section 117(f), Internal Revenue Code of 1939, to redemption of "Accumulative Installment Certificates." Here, Section 117(f) does not apply since we have a sale before maturity and not a redemption. Therefore, the exception created by Caulkins is not precedent for the claim of plaintiffs.

In Midland-Ross Corp. v. United States, 214 F. Supp. 631 (N.D. Ohio 1963), cited by the plaintiffs, the court rejected the distinction between the tax consequences of a sale and that of a redemption. The court stated, 214 F. Supp. at 631: "The combination of the Caulkins case with Section 117(f) thus indicates that appreciation realized on evidences of indebtedness, issued at an original issue discount and sold before maturity, constituted a capital gain and not regular income. The remaining question, therefore, is whether the legislative, administrative and judicial treatments of discount obligations support this indication." The court concluded "* * * while it is true that the recent cases have adopted the Government's position, they have done so (1) without a discussion of the historical treatment of gains resulting from original issue discount, and (2) only upon a rejection of the Caulkins case, which is controlling in this Circuit."

I cannot agree with the court in Midland-Ross, supra, that the legislative, judicial and administrative treatments support the conclusion that increments by way of original issue discounts on bonds sold before maturity must be treated as capital gains. Moreover, the Caulkins case does not support the court's conclusion for two reasons. First, on its facts it was wrongly decided; second, assuming Caulkins was correct, it provides no precedent for cases concerning the sale before maturity of original issue discount bonds.

In sum, it is clear that (1) Caulkins was wrongly decided; (2) even assuming Caulkins had been correctly de- [fol. 16] cided, it proves no precedent for the plaintiffs; and (3) the plaintiffs cannot estop the government on the basis of the Caulkins acquiescence.

The plaintiffs' claim for refund is narrowed to a single question: What is the tax treatment accorded to increments received from short-term, non-interest bearing notes issued at a discount? The answer is clear; that portion of any profit realized upon a subsequent sale of the notes which is attributable to the discount as well as any discount earned upon unsold notes is taxable as ordinary income and not capital gain.

Substance, reality and total effect of a particular transaction will determine the tax consequences thereof. Commissioner v. P. G. Lake Inc., 356 U. S. 260, 266 (1957). The forms or method of accounting for a transaction do not control, since "Their essence is determined not by the subtleties of draftsmanship but by their total effect. See Helvering v. Clifford, 309 U. S. 331; Harrison v. Schaffner, 312 U. S. 579." 356 U. S. at 266-67. In other words: "The law is not to be hoodwinked by colorable pretenses. It looks at truth and reality, through whatever disguise it may assume." Commonwealth v. Hunt, 45 Mass. 111, 129 (1842).

The "total effect" of the transactions which the partnership entered into makes it clear that the partnership earned interest, ordinary income, as a result of these discounts. The term "interest," as contained in the "gross income" definition contained in Section 22(a), Int. Rev. Code of 1939, is defined as the amount which one has contracted

to pay for the use of borrowed money. Old Colony Railroad Co. v. Commissioner, 284 U. S. 552, 560 (1932); Commissioner v. Morgan, 272 F. 2d 936, 939 (9 Cir. 1939); Jaglom v. Commissioner, 303 F. 2d 847, 850 (2 Cir. 1962). Although it is true that there may be some valid distinctions between interest and discounts, these distinctions are of little significance. A discount is in the nature of deferred [fol. 17] interest which may be amortized, for income tax purposes, over the life of the bonds. The Internal Revenue Service in computing the plaintiffs' tax liability did properly accrue their interest ratably over the period it was earned. 2 Mertens, Law of Federal Income Taxation, § 12.95, p. 276 (Zimet Rev. 1958); Continental Tie & Lumber Co. v. United States, 286 U. S. 290 (1932); United States v. Anderson, 269 U. S. 422 (1926).

The plaintiffs contend that the enactment of Section 1232, Int. Rev. Code of 1954, which treats increments from discounts as ordinary income, did effect a change in the laws governing the tax treatment of original issue discounts. This contention is without merit. As stated in Commissioner v. Morgan, 272 F. 2d 936, 941 (9 Cir. 1959):

> "* * * Respondents argue that by making this new provision for bonds issued in the future, Congress recognized that it effected a change and thereby recognized that the law previously was settled by the Caulkins decision. We think not. The Senate Report which accompanied the legislation (S. Rep. No. 1622, 83d Cong., 2d Sess. p. 112; 3 U. S. C. Cong. & Adm. News 1954, 4621, 4745), noted that there was 'some uncertainty as to the status of proceeds in these transactions. * * * The House bill removes doubt in this area.' We find here no evidence that the new enactment did any more than that."

The plaintiffs also contend that even if the original issue discount is taxable as ordinary income, the Internal Revenue Service erroneously accrued the income from the notes not sold by the partnership during the taxable year 1952. While the plaintiffs concede the partnership was on the accrual basis, they assert that the notes were really individual

investments of the taxpayers and not the property of the partnership and, hence, interest may not be accrued since the partner taxpayers were on the cash basis. The taxpayers state that there is an issue of fact as to the method [fol. 18] of accounting utilized in these investments since they state they used a cash rather than accrual basis. Therefore, they contend that none of the proceeds from the notes that were not sold or redeemed in 1952 should be included in the computation of the 1952 income of the partners.

The claim for refund as well as the complaint filed herein (paragraph 17(e) and (f)) allege that the securities were partnership property. There is no doubt that the partnership tax return was computed on the accrual basis in 1952. Therefore, the unsupported allegation in plaintiffs' statement pursuant to Rule 9(g) of the General Rules of the United States District Court for the Southern District of New York to the effect there remains a genuine issue of fact as to the method of accounting will not prevent the grant of complete summary judgment to the government. As Rule 56, Fed. R. Civ. P. makes clear: "When a motion for summary judgment is made and supported as provided in this rule, an adverse party may not rest upon mere allegations or denials of his pleadings, but his response, by affidavits or as otherwise provided in this rule, must set forth specific facts showing that there is a genuine issue for trial." This the plaintiffs have not done. Since this is a refund action the plaintiffs must not only demonstrate that the Commissioner's method of computation is wrong but also must establish the actual and precise method of computation which should have been utilized. Taylor v. Commissioner, 70 F. 2d 619, 620-21 (2 Cir.), aff'd 293 U. S. 507 (1935); Alvary v. United States, 302 F. 2d 90 (2 Cir. 1962).

Accordingly, the plaintiff's motion for summary judgment is denied and the defendant's motion for summary judgment is granted with costs.

Settle judgment on notice.

Dated: New York, N. Y., November 1, 1963.

Richard H. Levet, United States District Judge.

[fol. 19]

IN UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

AMENDED COMPLAINT

1. Plaintiffs bring this action against the United States for the recovery of income taxes illegally and erroneously assessed and collected from them. The plaintiffs, other than plaintiff Hubert R. A. Simon, are citizens of the United States and reside in the United States Judicial District known as the Southern District of New York. Plaintiff Hubert R. A. Simon is a citizen of Great Britain. Jurisdiction is conferred upon this Court by 28 U. S. C. Section 1346(a).

2. Plaintiffs W. Palmer Dixon and Joan Dixon at all times during the year 1952 were and still are husband and wife.

3. Plaintiffs Everett W. Cady and Clarissa H. Cady at all times during the year 1952 were and still are husband and wife.

4. On or about the 2nd day of December, 1956, the abovenamed Frank E. Gernon died leaving a Last Will and Testament which was thereafter and on the 28th day of December, 1956 duly admitted to probate by the Surrogate's Court of the County of Westchester, and letters testamentary thereof were duly issued by said Court to plaintiffs Helen J. Gernon and Helene J. Hirson on the [fol. 20] 28th day of December, 1956 and they thereupon duly qualified and thereafter acted and are still acting as such Executrices.

5. Plaintiff Helen J. Gernon is the widow of Frank E. Gernon, deceased.

6. Plaintiffs J. Herbert Higgins and Marion Blair Higgins at all times during the year 1952 were and still are husband and wife.

7. Plaintiffs Stephen A. Koshland and Carol F. Koshland are husband and wife.

8. On or about the 3rd day of January, 1955, the above-named Carl M. Loeb, Sr. died leaving a Last Will and Testament which was thereafter and on the 14th day of January, 1955 duly admitted to probate by the Surrogate's Court of the County of New York and letters testamentary thereof were duly issued by said Court to plaintiffs Henry A. Loeb, John L. Loeb, Carl M. Loeb, Jr. and Margaret L. Kempner on the 14th day of January, 1955 and they thereupon duly qualified and thereafter acted and are still acting as such Executors.

9. On or about the 28th day of November, 1953 the above-named Adeline M. Loeb died leaving a Last Will and Testament and Codicil thereto which were thereafter and on the 14th day of December, 1953 and on the 16th day of February, 1954 respectively, duly admitted to probate by the Surrogate's Court of the County of New York and letters testamentary thereof were duly issued by said Court to plaintiffs Henry A. Loeb, John L. Loeb, Carl M. Loeb, Jr. and Alan H. Kempner on the 14th day of December, [fol. 21] 1953 and they thereupon duly qualified and thereafter acted and are still acting as such Executors.

10. Plaintiffs John L. Loeb and Frances L. Loeb at all times during the year 1952 were and still are husband and wife.

11. Plaintiffs Henry A. Loeb and Louise S. Loeb at all times during the year 1952 were and still are husband and wife.

12. Plaintiffs Clifford W. Michel and Barbara R. Michel at all times during the year 1952 were and still are husband and wife.

13. Plaintiffs Mark J. Millard and Claire Millard at all times during the year 1952 were and still are husband and wife.

14. Plaintiffs Henry Parish, 2nd and Dorothy Parish at all times during the year 1952 were and still are husband and wife.

15. Plaintiffs Samuel L. Stedman and Gerda C. Stedman at all times during the year 1952 were and still are husband and wife.

16. Plaintiffs' claims are for the recovery of United States income taxes in the principal amount of $369,329.65 illegally and erroneously assessed and collected from them and/or their decedents for the calendar year 1952 together with interest thereon, as follows:

[fol. 22]

Plaintiffs	*Principal Amount of Income Tax*
W. Palmer Dixon and Joan Dixon	$ 18,874.12
Everett W. Cady and Clarissa H. Cady	10,870.08
Helen J. Gernon and Helene G. Hirson, as Executrices of the Last Will and Testament of Frank J. Gernon, deceased, and Helen J. Gernon	9,135.82
J. Herbert Higgins and Marion Blair Higgins	1,119.08
Stephen A. Koshland and Carol F. Koshland	4,570.96
Henry A. Loeb, John L. Loeb, Carl M. Loeb, Jr., and Margaret L. Kempner as Executors of the Last Will and Testament of Carl M. Loeb, Sr., deceased, and Henry A. Loeb, John L. Loeb, Carl M. Loeb, Jr. and Alan H. Kempner as Executors of the Last Will and Testament of Adeline M. Loeb, deceased	140,248.59
John L. Loeb and Frances L. Loeb	86,467.14
Henry A. Loeb and Louise S. Loeb	26,318.31
Clifford W. Michel and Barbara R. Michel	39,111.02

Plaintiffs	Principal Amount of Income Tax
Mark J. Millard and Claire Millard	18,022.74
Henry A. Parish, 2nd and Dorothy Parish	3,222.64
Hubert R. A. Simon	6,243.43
Samuel L. Stedman and Gerda C. Stedman	5,125.72

17. The facts upon which said claims are based are as follows:

[fol. 23] (a) During the year 1952 Armand G. Erpf, Samuel L. Hornstein, Frederick T. Koyle, A. Raymond McKernan and Hans A. Widenmann and plaintiffs W. Palmer Dixon, Everett W. Cady, J. Herbert Higgins, Stephen A. Koshland, John L. Loeb, Henry A. Loeb, Clifford W. Michel, Mark J. Millard, Henry Parish, 2nd, Hubert R. A. Simon, Samuel L. Stedman, Theodore Bernstein, Frank E. Gernon, Carl M. Loeb, Sr. and Adeline M. Loeb (hereinafter collectively referred to as the "Partners") were co-partners doing business under the firm name and style of Carl M. Loeb, Rhoades & Co. (hereinafter referred to as the "Partnership").

(b) From time to time during the year 1952 the Partnership acquired certain promissory notes (hereinafter referred to as "Commercial Paper") which had been issued at a discount. Some of the Commercial Paper was acquired from the issuer thereof; in most instances the Commercial Paper was acquired from a dealer.

(c) None of the Commercial Paper was issued by the United States or any possession thereof, nor by any State or territory or any political subdivision thereof, nor by the District of Columbia.

(d) Immediately following the acquisition of the Commercial Paper as aforesaid, the Commercial Paper was

clearly identified on the records of the Partnership as being held for investment purposes and was physically segregated from non-investment securities held by the Partnership in accordance with Section 117(a) of the Internal Revenue Code of 1939.

(e) From time to time during the year 1952, the Partnership sold portions of its investment holdings in the Commercial Paper prior to the maturity thereof. All of the Commercial Paper thus sold had been held for a period in excess of six months. In no instance was any sale made [fol. 24] to the issuer of the Commercial Paper in question. In entering into the transactions of acquisition alleged in subparagraph (b) of this paragraph and the transactions of sale alleged in this subparagraph (e), plaintiffs relied upon the case of *Caulkins* v. *Commissioner*, 1 T. C. 656 (1943), affirmed 144 F. 2d 482 (C. A. 6th, 1944), and on the Commissioner's acquiescence therein, as requiring the tax consequence that the profits on the sales would be capital gains.

(f) The partnership reported the difference between the sales prices of the Commercial Paper and the cost of the same to the Partnership as gain from the sale of capital assets held for a period in excess of six months and accordingly as long-term capital gain, and the Partners reported their respective distributive shares of said long-term capital gain and paid the tax thereon accordingly. The Commissioner of Internal Revenue sent statutory notices of deficiency in income taxes to the plaintiffs on the ground that the difference between the adjusted basis to the Partnership of the Commercial Paper and the sales price thereof constituted ordinary income in the nature of interest, and on the further ground that a pro rata portion of the difference between the adjusted basis of the Commercial Paper still held by the Partnership at the end of the calendar year 1952 and the face value at maturity of such Commercial Paper constituted accrued interest earned and was therefore includible as interest in the ordinary

income of the Partnership for that year, and taxable to the Partners to the extent of their distributable shares thereof.

(g) On the basis of the foregoing determinations, the aforementioned statutory notices of deficiency increased the distributable shares of Partnership ordinary income on the plaintiffs' returns for the year 1952 and reduced the distributable shares of net Partnership long-term capital gain reported on said return as follows:

[fol. 25]

Plaintiffs	*Increase in Ordinary Income*	*Decrease in Net Long-Term Capital Gain (50%)*
W. Palmer Dixon and Joan Dixon	$ 38,441.23	$ 12,357.28
Everett W. Cady and Clarissa H. Cady	23,064.74	7,414.37
Helen J. Gernon and Helene G. Hirson, as Executrices of the Last Will and Testament of Frank J. Gernon, deceased, and Helen J. Gernon	23,064.74	7,414.37
J Herbert Higgins and Marion Blair Higgins	5,766.19	1,853.59
Stephen A. Koshland and Carol F. Koshland	15,376.49	4,942.92
Henry A. Loeb, John L. Loeb, Carl M. Loeb, Jr., and Margaret L. Kempner as Executors of the Last Will and Testament of Carl M. Loeb, Sr., deceased, and Henry A. Loeb, John L. Loeb, Carl M. Loeb, Jr., and Alan H. Kempner as Executors of the Last Will and Testament of Adeline M. Loeb, deceased	215,270.92	69,200.78

Plaintiffs	Increase in Ordinary Income	Decrease in Net Long-Term Capital Gain (50%)
John L. Loeb and Frances L. Loeb	138,388.45	44,486.22
Henry A. Loeb and Louise S. Loeb	38,441.23	12,357.28
[fol. 26] Clifford W. Michel and Barbara R. Michel	61,505.97	19,771.65
Mark J. Millard and Claire Millard	38,441.23	12,357.28
Henry Parish, 2nd and Dorothy Parish	7,688.25	2,471.46
Hubert R. A. Simon	14,714.77	4,942.92
Samuel L. Stedman and Gerda C. Stedman	15,376.49	4,942.91

18. (a) As a result of the foregoing adjustments, the District Director of Internal Revenue, Lower Manhattan, erroneously assessed and between on or about April 25, 1957 and on or about May 2, 1957, collected additional income taxes from the plaintiffs in the amounts set forth in paragraph 16 above.

(b) On December 20, 1957 the plaintiffs duly filed with the District Director of Internal Revenue, Lower Manhattan, in accordance with the provisions of law in that regard and the regulations of the Secretary of the Treasury in pursuance thereof, claims for refund of the amounts set forth in paragraph 16 above which had been erroneously assessed and paid under protest to the District Director of Internal Revenue, Lower Manhattan, as aforesaid. Copies of such claims for refund are annexed hereto, made a part hereof, and marked Exhibits A to M, inclusive. The In-

ternal Revenue Service was apprised, in the course of its consideration of these said claims for refund, that one of the arguments of the taxpayers in support of said claims [fol. 27] was that in entering into the transactions of acquisition alleged in subparagraph (b) of paragraph 17 hereof and the transactions of sale alleged in subparagraph (c) of paragraph 17 hereof, plaintiffs relied upon the case of *Caulkins* v. *Commissioner,* 1 T. C. 656 (1943), affirmed 144 F. 2d 482 (C. A. 6th, 1944), and on the Commissioner's acquiescence therein, as requiring the tax consequence that the profits on the sales would be capital gains.

(c) More than six months have expired since the filing of the aforesaid claims for refund on December 20, 1957 and the commencement of this suit, and less than two years have elapsed from the denial thereof.

(d) No part of the income taxes in the amounts set forth in paragraph 16 hereof, together with interest thereon, as overpaid by plaintiffs have been refunded to the plaintiffs.

19. By virtue of the foregoing, defendant became and now is indebted to the plaintiffs in the respective amounts set forth in paragraph 16 hereof, together with interest as provided by law.

Wherefore, the plaintiffs now claim judgment against defendant as follows:

A. In favor of W. Palmer Dixon and Joan Dixon the amount of $18,874.12, together with interest thereon as allowed by law;

B. In favor of plaintiffs Everett W. Cady and Clarissa H. Cady in the amount of $10,870.08, together with interest thereon as allowed by law;

C. In favor of plaintiffs Helen J. Gernon and Helene G. Hirson, as Executrices of the Last Will and Testament of Frank E. Gernon, deceased, and Helen J. Gernon in the [fol. 28] amount of $9,135.82 together with interest thereon as allowed by law;

D. In favor of plaintiffs J. Herbert Higgins and Marion Blair Higgins in the amount of $1,119.08 together with interest thereon as allowed by law;

E. In favor of plaintiffs Stephen A. Koshland and Carol F. Koshland in the amount of $4,570.96, together with interest thereon as allowed by law;

F. In favor of plaintiffs Henry A. Loeb, John L. Loeb, Carl M. Loeb, Jr. and Margaret L. Kempner, as Executors of the Last Will and Testament of Carl M. Loeb, Sr. and in favor of plaintiffs Henry A. Loeb, John L. Loeb, Carl M. Loeb, Jr. and Alan H. Kempner, as Executors of the Last Will and Testament of Adeline M. Loeb in the amount of $140,248.69 together with interest thereon as allowed by law;

G. In favor of plaintiffs John L. Loeb and Frances L. Loeb in the amount of $86,467.14 together with interest thereon as allowed by law;

H. In favor of plaintiffs Henry A. Loeb and Louise S. Loeb, in the amount of $26,318.31 together with interest thereon as allowed by law;

I. In favor of plaintiffs Clifford W. Michel and Barbara R. Michel in the amount of $39,111.02 together with interest thereon as allowed by law;

J. In favor of plaintiffs Mark J. Millard and Claire Millard in the amount of $18,022.74 together with interest thereon as allowed by law;

K. In favor of plaintiffs Henry Parish, 2nd and Dorothy Parish in the amount of $3,222.64 together with interest thereon as allowed by law;

[fol. 29] L. In favor of plaintiff Hubert R. A. Simon in the amount of $6,243.43 together with interest thereon as allowed by law;

M. In favor of plaintiffs Samuel L. Stedman and Gerda C. Stedman in the amount of $5,125.72 together with interest thereon as allowed by law;

together with costs and such other relief as may to this honorable Court seem just and proper.

Stroock & Stroock & Lavan, By: Bernard E. Brandes,
A Member of the Firm, Attorneys for Plaintiffs.

(Copies of the refund claims annexed as exhibits A through M of the Amended Complaint have been omitted.)

[fol. 30]

IN UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

ANSWER

Now comes the above-named defendant, by its attorney, S. Hazard Gillespie, Jr., United States Attorney in and for the Southern District of New York, and for its answer to the complaint filed herein alleges as follows:

I.

Admits the allegations contained in the first sentence of paragraph 1 thereof, except that it is denied that the taxes sought to be recovered were illegally and erroneously assessed and collected from plaintiffs. Admits the allegations contained in the second sentence of said paragraph, except that the defendant is presently without knowledge or information sufficient to form a belief as to the truth of the allegation that plaintiff Hubert R. A. Simon is a citizen of Great Britain. Admits the allegations contained in the third sentence of said paragraph.

II. through XV.

The defendant is presently without knowledge or information sufficient to form a belief as to the truth of the allegations contained in paragraphs numbered 2 through 15 thereof.

XVI.

Admits the allegations contained in paragraph numbered 16 thereof, except that it is denied that the additional income [fol. 31] taxes for the calendar year 1952, together with interest thereon, referred to in said paragraph, were illegally and erroneously assessed and collected from plaintiffs and/or their decedents, as alleged in said paragraph.

XVII.

Admits the allegations contained in subparagraph (a) of paragraph 17 thereof. The defendant is presently without knowledge or information sufficient to form a belief as to the truth of all of the allegations contained in subparagraphs (b) through (f) thereof. Admits the allegations contained in subparagraph (g) thereof.

XVIII.

Denies the allegations contained in subparagraph (a) of paragraph 18 thereof, except that it is admitted that the additional income taxes assessed against plaintiffs as a result of the adjustments referred to in subparagraph (g) of paragraph 17 thereof and as set forth in paragraph 16 of the complaint were paid on or about the dates alleged in said subparagraph. Denies the allegations contained in the first sentence of subparagraph (b) of paragraph 18, except that the defendant admits that claims for refund of the amounts set forth in paragraph 16 of the complaint were filed with the District Director of Internal Revenue, Lower Manhattan, on December 20, 1957. For answer to the second sentence of subparagraph (b) of paragraph 18 thereof, the defendant denies each and every allegation contained in said claims for refund, copies of which are annexed to the complaint as Exhibits A to M, inclusive. Admits the allegations contained in subparagraph (c) of paragraph numbered 18 thereof. Admits the allegations contained in subparagraph (d) of paragraph 18 thereof, except it is denied that there was any overpayment by plaintiffs of taxes or interest sought to be recovered in this action.

[fol. 32] XIX.

Denies the allegations contained in paragraph numbered 19 thereof.

Wherefore, defendant prays that the complaint filed herein be dismissed, with costs to be assessed against the plaintiff.

S. Hazard Gillespie, Jr., United States Attorney for the Southern District of New York, Attorney for Defendant, by Stephen Kurzman, Assistant United States Attorney.

[fol. 33]

IN UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

DEFENDANT'S NOTICE OF MOTION FOR SUMMARY JUDGMENT—May 27, 1963

Sirs:

Please Take Notice that upon the annexed statement pursuant to Rule 9(g) and memorandum of law, and upon all papers and proceedings heretofore had or filed herein, the defendant, United States of America, will move this Court, at a term for motions, in Room 506, U. S. Courthouse, Foley Square, New York, N. Y., on June 11, 1963, at 10:00 o'clock in the forenoon or as soon thereafter as counsel may be heard, for summary judgment, pursuant to Rule 56 of the Federal Rules of Civil Procedure, dismissing the complaint with prejudice and with costs.

Dated: New York, N. Y., May 27, 1963.

Yours, etc.,

Robert M. Morgenthau, United States Attorney for the Southern District of New York, Attorney for Defendant.

[fol. 34] To: Stroock & Stroock & Lavan, Esqs., Attorneys for Plaintiffs, 61 Broadway, New York 6, N. Y.

IN UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

DEFENDANT'S STATEMENT PURSUANT TO RULE 9(G), READ IN SUPPORT OF DEFENDANT'S MOTION FOR SUMMARY JUDGMENT—May 27, 1963

1. This Court has jurisdiction over this action for the refund of taxes for the taxable year, 1952, pursuant to 28 U. S. C. 1346(a).

2. During the year 1952 plaintiffs herein were members of the partnership known as Carl M. Loeb, Rhoades & Co. (hereinafter termed "the partnership").

3. Plaintiffs, as partners of said partnership, were engaged in the business of dealing as agents for customers in securities and commodities transactions, the underwriting and selling of securities, and trading and investing for the account of the firm.

4. The firm's books and records were regularly kept on the accrual basis of accounting and its tax returns were filed on the accrual basis. Plaintiffs are thus required to report their distributive share of the partnership's income as computed upon the accrual basis.

5. During the year 1952 the partnership acquired thirty-three (33) ordinary short-term promissory notes, com- [fol. 35] monly known as "commercial paper," in the total face amount of $43,050,000, consisting of $34,000,000 worth of said notes in United States dollars and $9,050,000 worth of same in Canadian dollars. A schedule indicating the obligor corporations which issued the notes, the dates and prices of their purchase and sale by the partnership, their face value, and the profit realized upon sale is hereto annexed as Schedule "A".

6. Said promissory notes were purchased by the partnership on the original dates of issue in all but one in-

stance, either directly from the respective corporations which issued the notes or through agents thereof or dealers.

7. Said promissory notes bore maturity dates from 190 to 272 days from the dates of issue.

8. No provision was made by the terms of any of said promissory notes for the payment of any interest.

9. Said promissory notes were issued at a discount ranging from 2⅜ to 3¾ per cent of face value and the partnership paid for each of the notes this exact discounted price for which the notes were originally issued. The total purchase price for the notes was $42,222,357.21, consisting of $33,374,235.39 in United States Dollars and $8,848,121.82 in Canadian dollars. (See Schedule "A").

10. The notes were segregated and identified as being held for investment in accordance with Section 117(n) of the Internal Revenue Code of 1939.

11. Upon purchase, these notes would be used as collateral to secure loans equal to the face value thereof from various bankers. The total interest paid on such loans in the sum of $624,000.54 was claimed as a deduction upon plaintiffs' tax returns for the year herein in issue.

[fol. 36] 12. During the year 1952, prior to the respective dates of maturity of the notes and after holding said notes for more than 6 months, the partnership sold twenty of the notes for which it had paid $26,501,534.00 for the sum of $26,996,062.68, thereby realizing a profit in the sum of $494,528.68. (See Schedule "A"). In its income tax returns for the year 1952 the partnership reported said difference between the sales price of said notes and the cost to the partnership, or $494,528.68, as gain from the sale of capital assets held for the period in excess of 6 months, ("long term capital gain") and the partners (the plaintiffs herein) reported their respective distributive shares of said gain and paid the tax thereon accordingly.

13. The Commissioner of Internal Revenue duly assessed income tax deficiencies against plaintiffs upon the following grounds:

a. That the amount of the discount which was earned during the taxable year 1952 by the plaintiffs constituted ordinary income and not capital gain;

b. That said amount of discount constitutes the difference between the face value of the notes and the lesser amounts paid therefor by the partnership, and,

c. That said difference, divided by the number of days between issue date and maturity date, results in the amount of discount earned each day the notes were held by the partnership (See next to last column of Schedule "A"), and

d. That the amount of discount earned per day multiplied by the number of days the notes were held during 1952 constitutes ordinary income to plaintiffs and not capital gain as they had reported it on their returns; in the case of the notes which were sold prior to the close of 1952, said "earned discount" (See Schedule "A") exceeded the profit realized in each instance save one (the Industrial [fol. 37] Acceptance Corp. Ltd. note) so that the entire aforesaid profit of $494,528.68 upon sale of the notes constituted ordinary income and not capital gain, except for the sum of $924.94, representing the excess of the profit over the earned discount and which did constitute capital gain in the sole aforementioned instance;

e. That as to the notes which were not sold during 1952, the amount of the discount earned per day multiplied by the number of days the notes were held until the close of the year constituted ordinary income to plaintiffs, since the partnership was on the accrual basis of accounting.

f. All of which resulted in adjustments decreasing plaintiffs' capital gain and increasing their ordinary income as is fully set forth in Paragraph 17(g) of the complaint herein, and corresponding deficiencies in tax, as is set forth in Paragraph 16 of the complaint herein, of which plaintiffs were duly notified by notices of deficiencies.

14. Plaintiffs paid said deficiencies, filed timely claims for refund, and commenced this action for the recovery thereof.

Dated: New York, N. Y., May 27, 1963.

Yours, etc.,

Robert M. Morgenthau, United States Attorney for the Southern District of New York, Attorney for United States of America.

(Schedule A annexed to Defendant's Statement Pursuant to Rule 9(g) has been omitted.)

[fol. 38]

IN UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

PLAINTIFFS' NOTICE OF CROSS-MOTION FOR SUMMARY JUDGMENT—August 23, 1963

Sir:

Please Take Notice that upon the annexed statement pursuant to Rule 9(g) and Plaintiffs' memorandum of law, and upon the statement pursuant to Rule 9(g) filed in support of Defendant's motion for summary judgment, and upon all papers and proceedings heretofore had or filed herein, the Plaintiffs will move this Court, at a Term for motions, in Room 506, U. S. Courthouse, Foley Square, New York, N. Y., on the 10th day of September, 1963, at 10:00 A. M., or as soon thereafter as counsel may be heard, for summary judgment, pursuant to Rule 56 of the Federal Rules of Civil Procedure, with costs.

Dated: New York, New York, August 23, 1963.

Yours, etc.,

Stroock & Stroock & Lavan, Esqs., Attorneys for Plaintiffs.

To: Hon. Robert M. Morgenthau, United States Attorney for the Southern District of New York, Attorney for Defendant.

[fol. 39]

IN UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

PLAINTIFFS' STATEMENT PURSUANT TO RULE 9(g) ON DEFENDANT'S MOTION AND ON PLAINTIFFS' CROSS-MOTION—August 23, 1963

I.

Plaintiffs admit that the paragraphs of Defendant's statement pursuant to Rule 9(g) state material facts as to which no genuine issue exists except as to paragraph 4, which states facts as to which a genuine issue remains to be tried.

II.

In support of Plaintiffs' cross-motion for summary judgment, and in opposition to Defendant's motion, Plaintiffs contend that additional facts as to which no genuine issue remains to be tried are as follows:

1. The books and records of Carl M. Loeb, Rhoades & Co. ("the partnership") in connection with its brokerage and general business activities are kept on the accrual basis of accounting. During the taxable year here involved, as well as many years prior thereto, the partnership's books and records in connection with its activities for its own account, such as the buying and selling of securities as principal, were kept on the cash basis. The tax returns of the partnership reflect the methods of bookkeeping thus employed.

[fol. 40] 2. The securities referred to as "commercial paper" which are the securities involved in the within action were purchased by the partnership as principal for its own account as a partnership investment. During the taxable year here involved, as well as for many years prior thereto, the accounting as well as the reporting for tax purposes in connection with partnership investments was on a cash basis.

3. In Office Decision 1024, 1920 Cum. Bull. 189, the Commissioner of Internal Revenue ruled that original issue discount is not taxable interest.

4. Legislative history in connection with Revenue legislation prior to the Internal Revenue Code of 1954 demonstrates the Treasury Department position that original issue discount is not interest.

5. On December 25, 1944, the Commissioner of Internal Revenue published his Acquiescence in the case of *Caulkins v. Commissioner,* 1 T. C. 656, *aff'd* 144 F. 2d 482 (C. A. 6th, 1944).

6. On March 12, 1952 the Commissioner of Internal Revenue issued a special ruling published in 525 CCH Standard Federal Tax Reporter, Para. 6161, which held that no withholding for income tax purposes was required as regards original issue discount realized by non-resident aliens (which withholding would have been required had original issue discount been the equivalent of interest) and that such original issue discount was taxable as capital gain when realized, as to which gain a non-resident alien could have a United States tax liability only under the limited circumstances set forth in the Internal Revenue Code with regard to capital gains realized by nonresident aliens.

[fol. 41] 7. Consistently with the position of the Treasury Department, as demonstrated by the aforementioned Office Decision, Acquiescence and Special Ruling, and in other respects as hereinabove set forth, the gain realized by the partnership upon the sale of the securities here involved was capital gain and the Defendant's representatives should have held consistently that original issue discount was not interest to be accrued ratably as earned.

8. All of the securities (commercial paper) here involved were purchased by the partnership prior to July 6, 1953.

9. The partnership, when purchasing such securities, was aware of the then position of the Internal Revenue

Service as hereinabove set forth, and made such purchases in reliance thereon.

10. No published doubt existed with regard to the position of the Internal Revenue Service until July 6, 1953, when there was published Revenue Ruling 119, 1953-2 Cum. Bull. 95, in which it is stated that the decision in the *Caulkins* case and the Acquiescence therein should be limited strictly to what was therein decided.

11. On March 11, 1955 the Commissioner of Internal Revenue withdrew his Acquiescence in the *Caulkins* case, and on June 25, 1956, in Revenue Ruling 56-299, 1956-1 Cum. Bull. 603, amplified his position by ruling that no basis existed for differentiating the debt instrument in the *Caulkins* case from other debt instruments issued at a discount, that in all cases original issue discount was the equivalent of interest, but that no retroactive effect would be given this change of position except as to the type of debt instrument of the particular issuer, as involved in the *Caulkins* case, provided such securities were purchased dur- [fol. 42] ing the period December 25, 1944, the date the Acquiescence in the *Caulkins* case was announced, and December 31, 1954.

12. If the change of position by the Treasury Department is sustained and made applicable to the partnership, the latter and its partners, including the Plaintiffs herein, will sustain injury therefrom.

13. The partnership would not have made this type of investment had the position of the Treasury Department been otherwise.

14. In limiting the retroactive effect of Revenue Ruling 56-299, *supra*, to the specified securities of a specified issuer, the Commissioner of Internal Revenue abused the discretion given him in Section 3791(b) of the Internal Revenue Code of 1939.

Dated: New York, New York, August 23, 1963.

Yours, etc.,

Stroock & Stroock & Lavan, Attorneys for Plaintiffs.

[fol. 43]

IN UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

PLAINTIFFS' SUPPLEMENTAL STATEMENT PURSUANT TO RULE 9(G) ON DEFENDANT'S MOTION AND ON PLAINTIFFS' CROSS-MOTION—October 4, 1963

15. The investigation by the Treasury Department of the merits of the claims for refund would have apprised the defendant that the partnership and its partners, including the plaintiffs herein purchased such securities (the commercial paper here involved) in reliance upon the position of the Internal Revenue Service as demonstrated by the acquiescence in the *Caulkins* decision and upon the interpretation of the Internal Revenue Code made in the *Caulkins* case as acquiesced.

16. That the partnership relied upon the aforementioned position of the Treasury Department in making the investment hereinabove referred to was known to the Treasury Department and therefore to defendant.

Dated: New York, New York, October 4, 1963.

Yours, etc.,

Stroock & Stroock & Lavan, Attorneys for Plaintiffs.

[fol. 44] [File endorsement omitted]

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT
Docket No. 28752

W. PALMER DIXON, JOAN DIXON, EVERETT W. CADY, CLARISSA H. CADY, J. HERBERT HIGGINS, MARION BLAIR HIGGINS, STEPHEN A. KOSHLAND, HENRY A. LOEB, JOHN L. LOEB, CARL M. LOEB, JR. and MARGARET L. KEMPNER, as Executors of the Last Will and Testament of CARL M. LOEB, SR., Deceased, HENRY A. LOEB, JOHN L. LOEB, CARL M. LOEB, JR., and ALAN H. KEMPNER, as Executors of the Last Will and Testament of ADELINE M. LOEB, Deceased, JOHN L. LOEB, FRANCES L. LOEB, HENRY A. LOEB, LOUISE S. LOEB, CLIFFORD W. MICHEL, BARBARA R. MICHEL, MARK J. MILLARD, CLAIRE MILLARD, HENRY PARISH 2ND, DOROTHY PARISH, HUBERT R. A. SIMON, SAMUEL L. STEDMAN and GERDA C. STEDMAN, Plaintiffs-Appellants,

HELEN J. GERNON and HELENE G. HIRSON, as Executrices of the Last Will and Testament of FRANK E. GERNON, Deceased, HELEN J. GERNON, Plaintiffs,

—against—

THE UNITED STATES OF AMERICA, Defendant-Appellee.

APPENDIX FOR THE UNITED STATES OF AMERICA—
Filed April 16, 1964

[fol. 45]

IN UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

60 Civ. 2134

W. PALMER DIXON, *et al.*, Plaintiffs,

v.

UNITED STATES OF AMERICA, Defendant.

AFFIDAVIT IN SUPPORT OF DEFENDANT'S MOTION FOR SUMMARY JUDGMENT—Sworn to September 27, 1963

State of New York,
County of New York,
Southern District of New York—ss.:

Robert Arum, being duly sworn, deposes and says:

1. I am an Assistant United States Attorney in the office of Robert M. Morgenthau, United States Attorney for the Southern District of New York, and as such I am in charge of and fully familiar with the above-entitled action.

2. In accordance with the usual procedure in tax refund cases, the Internal Revenue Service, after an action [fol. 46] has been commenced by a taxpayer, forwards its files pertaining to the matters raised in the litigation to the Department of Justice. These files are then placed in the custody of the attorney handling the case. Accordingly, as the attorney in charge of this litigation, I presently have custody of the files of the Internal Revenue Service relating to the matters raised by the taxpayers in this litigation.

3. As is set forth in paragraph 17(a), the plaintiffs named therein were partners in the firm of Carl M. Loeb, Rhoades & Co. ("the Partnership"). The books and records of the partnership were regularly kept on the ac-

crual basis of accounting and the tax returns were prepared by the partnership on the accrual basis. A photostatic copy of the partnership tax return for the year 1952 which was filed by the partnership on March 16, 1953 is attached as Exhibit A. The distributive share of each of the partners in the income and expense of the partnership, as computed on the accrual basis, is set forth on a schedule attached to the said tax return. As further appears from the said tax return, the securities involved in this litigation were reported on the said return as an asset of the partnership and the distributive share of each of the partners in the results of the transactions relating to the securities was reported on the said tax return.

4. In 1956 when the District Director first proposed to assess deficiencies with respect to the treatment by Carl M. Loeb, Rhoades & Co. ("the partnership") of the securi- [fol. 47] ties transactions here in question, the partners were afforded an opportunity in accordance with the usual practice of the Internal Revenue Service, to protest against the proposed deficiencies. Henry A. Loeb, a general partner in the partnership, filed a protest, under oath, on behalf of himself and the other persons who were partners in the partnership during the calendar year 1952. A copy of the said protest, which was signed under oath by Mr. Loeb, is attached hereto as Exhibit B. In the protest Mr. Loeb set forth the facts upon which the objections to the proposed deficiencies were based. Mr. Loeb alleged that the securities constituted holdings of the partnership and were capital assets in the hands of the partnership. At no place in the statement of facts upon which the protest was based or anywhere else in the aforesaid protest did Mr. Loeb maintain that the partnership had purchased the securities in question in reliance on the acquiescence by the Commissioner in the *Caulkins* case or on other administrative determination.

5. Prior to the commencement of the above-entitled action, the District Director, in accordance with the provisions of §3772(a)(2) of the 1939 Code, gave notice to all of the plaintiffs, by registered mail, of the disallowance

in full of their claims for refund for the year 1952, upon which this litigation is based.

Wherefore, your deponent respectfully prays that the Court grant the motion of the defendant, United States of America, for summary judgment; deny plaintiffs' cross-motion for summary judgment; dismiss plaintiffs' com- [fol. 48] plaint with prejudice; award the United States the costs of this action; and grant to the United States such other and further relief as to the Court may seem just and proper.

Robert Arum, Assistant U. S. Attorney.

In United States District Court

Southern District of New York

Affidavit in Opposition to Plaintiffs' Motion for Leave to Amend Complaint and in Support of the Defendant's Motion for Summary Judgment—Sworn to October 14, 1963

State of New York,
County of New York,
Southern District of New York—ss.:

Robert Arum, being duly sworn, deposes and says:

1. I am an Assistant United States Attorney in the office of Robert M. Morgenthau, United States Attorney for the Southern District of New York, and as such I am in charge of and fully familiar with the above-entitled action.

[fol. 49] 2. This affidavit, which is supplementary to my previous affidavit dated September 27, 1963, heretofore filed with this Court, is made in opposition to the plaintiffs' motion to amend its complaint and in support of the Government's motion for summary judgment.

3. With respect to the Government's legal argument in opposition to the motion to amend the complaint, we

respectfully refer to the Point II of the Government's reply brief heretofore filed with this Court.

4. This affidavit is designed to furnish this Court with certain information in the files of the Government which contradicts various statements and assertions made in the affidavit of Bernard E. Brandes, sworn to on October 10, 1963, and served October 11, 1963 on the United States Attorney's Office.

5. As stated in paragraph 2 of my affidavit of September 27, 1963, I presently have custody of the files of the Internal Revenue Service relating to the matters raised by the taxpayers in this litigation.

6. In paragraph 5 of his affidavit of October 10, 1963, Mr. Brandes states that he pointed out to the Agent who audited the partnership return that the partnership had purchased the securities on the strength of the acquiescence in the *Caulkins* case and in reliance on it. The internal report of Revenue Agent Frank Amari, who audited the partnership return for the year 1952, does not make [fol. 50] reference in any way to the reliance issue. A copy of this internal report of Agent Amari is attached to this affidavit as Exhibit 1. Although Mr. Brandes states in paragraph 5 of his affidavit that he discussed the reliance question with the Agent on the audit of the partnership return, the report of Agent Amari shows that the discussions were had only with Mr. Laufer, a C.P.A., and a Mr. M. Barash, the Office Manager of the partnership. Furthermore, Mr. Amari has informed your deponent that at no time did the plaintiffs or any of their representatives, including Mr. Brandes, tell him that the partnership had acquired the securities in reliance on the *Caulkins* acquiescence. The Government is prepared, if necessary, to submit Mr. Amari's affidavit on this point.

7. In paragraph 6 of his affidavit, Mr. Brandes states that he participated in a meeting with Mr. Amari's supervisor to take up the questions arising as the result of the audit. Mr. Brandes states that he made statements to the supervisor that the partnership had purchased the securities in reliance on the Commissioner's acquiescence

in the *Caulkins* case. The meeting referred to by Mr. Brandes in paragraph 6 of his affidavit is called in the Revenue Service an "Informal Conference." A copy of the report prepared by Mr. Amari's Group Supervisor with respect to this conference is attached to this affidavit as Exhibit 2. There is absolutely no reference in this report to the reliance question which the plaintiffs seek to raise here in their amended complaint.

[fol. 51] 8. Thereafter, as stated in paragraph 4 of my affidavit of September 27, 1963, the District Director sent to the plaintiffs notices of proposed deficiencies. In accordance with the usual procedure, the plaintiffs filed a protest to the proposed deficiencies. The protest filed by the partnership on behalf of the plaintiffs was annexed as Exhibit B to my affidavit of September 27, 1963. At no place in such protest did the plaintiffs maintain that the partnership had purchased the securities in question in reliance on the acquiescence by the Commissioner in the *Caulkins* case, or on any other administrative determination.

9. In paragraph 7 of his affidavit, Mr. Brandes refers to conferences with the Appellate Division of the Internal Revenue Service concerning the protest filed by the partnership. Mr. Brandes states that he discussed with the personnel of the Appellate Division "the further point that the taxpayer relied on the acquiescence in entering into the transactions." Attached as Exhibit 3 to this affidavit is the "Action Memorandum" prepared by the Appellate Division on the partnership's protest. Also part of the "Action Memorandum" was a supporting statement justifying the position that deficiency notices be sent to the taxpayers. Every portion of the supporting statement, which relates to securities transactions, has been reproduced and included in Exhibit 3 to this affidavit. Page 3 of the supporting statement refers to a conference on November 8, 1956, attended by Mr. Brandes. At [fol. 52] no place in either the Action Memorandum or in the supporting statement is there any reference at all which even remotely deals with the reliance issue which the plaintiffs seek to raise in their amended complaint.

10. As a result of the recommendation in the Action Memorandum, notices of deficiency were sent to the plaintiffs by registered mail. A copy of the notice of deficiency or, "90-day letter" sent to Mr. W. Palmer Dixon, one of the plaintiffs here, is attached to this affidavit as Exhibit 4.

11. Thereafter, the taxpayers agreed to pay the deficiencies in tax with respect to the securities transactions issue. The supplemental "Action Memorandum" relating to this decision of the taxpayers is attached to this affidavit as Exhibit 5.

12. After the payment of the deficiencies, the plaintiffs filed claims for refund with the District Director. Copies of the claims are attached to the complaint filed herein by the plaintiffs. At no place in the claim for refund is there any reference made to the reliance issue.

13. The refund claims were referred to Revenue Agent Amari and the District Director informed the plaintiffs that he proposed to reject the refund claims. The report of Revenue Agent Amari was annexed to the District Director's letter to the plaintiffs informing them of the proposed rejection of the refund claims. A copy of the District Director's letter to W. Palmer Dixon, one of the [fol. 53] plaintiffs here, together with the annexed report of Revenue Agent Amari, is attached to this affidavit as Exhibit 6. The report of Revenue Agent Amari makes absolutely no reference to the reliance issue.

14. Attached to this affidavit as Exhibit 7 is the report of Agent Amari prepared for the internal use of the Internal Revenue Service. This report again mak s no reference to the reliance issue.

15. As stated in paragraph 9 of Mr. Brandes' affidavit, the plaintiffs waived any further conferences with the Service in connection with the refund claims. Thereafter, the District Director mailed formal notices of disallowance of the plaintiffs' refund claims. A copy of the formal notice of disallowance mailed to Mr. W. Palmer Dixon, one of the plaintiffs here, is attached to this affidavit as

Exhibit 8. Similar notices of disallowance were mailed to all of the plaintiffs in this action prior to the commencement of this refund suit.

Wherefore, it is respectfully requested that plaintiffs' motion to amend the complaint be denied; that summary judgment in this action be awarded to the United States; that plaintiffs' cross-motion for summary judgment be denied; and that plaintiffs' complaint be dismissed with prejudice and with costs.

Robert Arum, Assistant United States Attorney.

[fol. 54]

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 451—September Term, 1963.

Argued April 30, 1964

Docket No. 28752

W. PALMER DIXON, JOAN DIXON, EVERETT W. CADY, CLARISSA H. CADY, J. HERBERT HIGGINS, MARION BLAIR HIGGINS, STEPHEN A. KOSHLAND, HENRY A. LOEB, JOHN L. LOEB, CARL M. LOEB, JR. and MARGARET L. KEMPNER, as Executors of the Last Will and Testament of CARL M. LOEB, SR., Deceased, HENRY A. LOEB, JOHN L. LOEB, CARL M. LOEB, JR., and ALAN H. KEMPNER, as Executors of the Last Will and Testament of ADELINE M. LOEB, Deceased, JOHN L. LOEB, FRANCES L. LOEB, HENRY A. LOEB, LOUISE S. LOEB, CLIFFORD W. MICHEL, BARBARA R. MICHEL, MARK J. MILLARD, CLAIRE MILLARD, HENRY PARISH 2ND, DOROTHY PARISH, HUBERT R. A. SIMON, SAMUEL L. STEDMAN and GERDA C. STEDMAN, Plaintiffs-Appellants,

HELEN J. GERNON and HELENE G. HIRSON, as Executrices of the Last Will and Testament of FRANK E. GERNON, Deceased, HELEN J. GERNON, Plaintiffs,

—v.—

THE UNITED STATES OF AMERICA, Defendant-Appellee.

[fol. 55] Before: Moore, Smith and Kaufman, Circuit Judges.

Appeal from a judgment of the United States District Court for the Southern District of New York, Levet, *J.*, awarding summary judgment to the United States in an ac-

tion for the refund of income taxes paid. 224 F. Supp. 358 (S. D. N. Y. 1963).

Affirmed.

Bernard E. Brandes, of Stroock & Stroock & Lavan, New York, N. Y. (Sanford Saideman, of counsel), for plaintiffs-appellants.

Robert Arum, Assistant United States Attorney for the Southern District of New York, New York, N. Y. (Robert M. Morgenthau, United States Attorney, of counsel), for defendant-appellee.

OPINION—June 19, 1964

KAUFMAN, *Circuit Judge*:

The sole question presented by this appeal is whether profits attributable to original issue discount on "commercial paper," defined as short-term, non-interest-bearing commercial obligations, are taxable at ordinary income or capital gains rates under the Internal Revenue Code of 1939.[1]

[fol. 56] The relevant facts in this case are free from dispute. Thus, the plaintiffs' amended complaint reveals that during the taxable year 1952, the taxpayers or their spouses or decedents were partners in the investment firm of Carl M. Loeb Rhoades & Co., a member of the New York and American Stock Exchanges. At various times during the year, the partnership purchased thirty-three short-term, non-interest-bearing notes, either directly from the obligor corporation, or through agents or dealers. The notes bore maturity dates ranging from 190 to 272 days from the date of issue, and all were issued at discounts, which varied between 2⅜% and 3¾% of face value. At the close of the

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[1] Unlike the 1954 Code, see *infra*, the Internal Revenue Code of 1939 did not contain any specific provisions with respect to original issue discount. The relevant statutory sections, therefore, are merely §22, which included "interest" in its general definition of "gross income," and §117, which provided for capital gains treatment upon the sale or exchange of a "capital asset."

taxable year, only thirteen notes remained on hand and unmatured; the remaining twenty had been sold during the year—all more than six months after they had been purchased.

In preparing their income tax returns for 1952, each partner reported as a long-term capital gain his distributive share of the profits realized upon twenty notes that had been sold, and no account was taken of the thirteen which remained on hand. Rejecting these computations, the Commissioner determined deficiencies totalling some $369,-329.65. In place of the taxpayers' method of analysis, he computed the income earned by virtue of the discount for each day that each of the thirty-three notes were held by the partnership. This earned discount per day was then multiplied by the number of days that the notes were held, and the resulting amount was considered as earned interest, and afforded ordinary income treatment. Having paid the deficiencies assessed, the taxpayers brought this action for a refund.

On cross-motions for summary judgment below, Judge Levet found that the Commissioner had properly interpreted the relevant provisions of the 1939 Code, in viewing the profit derived from the discount as equivalent to interest [fol. 57] income, and accordingly taxing it at ordinary income rates. Although recognizing that §1232 of the Internal Revenue Code of 1954 specifically provides for ordinary-income treatment in original issue discount situations, he concluded that this section was merely intended to clarify the existing law, rather than representing an abrupt departure from the earlier practice. As a result, Judge Levet awarded judgment to the Commissioner, and the taxpayers have brought this appeal.

We should note at the outset that a narrow issue is presented for our decision. It is the taxpayers' contention that the original issue discount resulted in a long-term capital gain, which could only be realized on the twenty notes which were sold; the Commissioner, on the other hand, asserts that the discount produced interest income which must properly be computed for the period that all of the notes were held by the partnership. This dispute as to whether capital gains or ordinary income treatment was

appropriate, moreover, is the only issue that divides the parties. Thus, no question has been raised as to the propriety of taxing the individual partners for notes held by the partnership, and the taxpayers have conceded that if the discount *did* represent ordinary income, that income was realized upon each of the thirty-three notes held, and was not dependent upon a sale.

Turning, then, to the single question in dispute, we find the approach adopted by the Commissioner and upheld below to be plainly correct. Indeed, unless form rather than substance is to carry the day, such a conclusion seems inescapable in light of the facts here conceded. Thus, we are aware of no meaningful distinction, and the taxpayers have offered none, between the discount income involved here and the more traditional forms of "interest on indebtedness," defined in *Deputy* v. *duPont*, 308 U. S. 488, 498 (1940), as "compensation for the use or forbearance of [fol. 58] money." Whatever superficial or mechanical differences in form, both are designed to accomplish the same objective—the production of income for "the hire of money." And this factual identity between discount income, as employed here, and interest income seems both crucial and apparent. In the terms of an illustration offered by the Commissioner, there should be no distinction for tax purposes between a case in which $10,000 is advanced by a lender in exchange for a $10,000 note, payable in one year with interest at 6%, and the original issue discount situation, in which the same $10,000 would be loaned in exchange for a note in the face amount of $10,600. When these transactions are reduced to their essentials, it becomes plain that in both cases, the lender has advanced $10,000, and has received that amount in return, plus $600 in interest. It would seem arbitrary to insist, as do the taxpayers, that significant tax consequences should hinge upon whether this $600 sum is separately stated as interest or is included in the face amount of the note. It has been repeatedly emphasized that our taxing statutes are intended to take cognizance of realities and not mere appearances or facades. See, e.g., *Commissioner* v. *P. G. Lake, Inc.*, 356 U. S. 260, 266-67 (1958).

Without denying the force of this reasoning, the taxpayers argue, however, that capital gains treatment is compelled by the decision in *Caulkins* v. *Commissioner*, 144 F. 2d 482 (6th Cir. 1944). The taxpayer there paid some $15,043.33 over a ten-year period for an "accumulated installment certificate" which returned him $20,000 when the certificate was redeemed. Although recognizing that the certificate was an "evidence of indebtedness" and that the increment in value represented "consideration paid for the use of the amounts paid in," the Court of Appeals for the Sixth Circuit held that the difference between the amount [fol. 59] paid and the sum received on redemption was taxable as a long-term capital gain.

We are willing to agree for present purposes that the notes involved here are analogous to the certificate at issue in *Caulkins.* But in light of our conclusion that original issue discount income is indistinguishable from interest income, we are of the opinion that the *Caulkins* case was wrongly decided. In so holding, we find ourselves in agreement with the greater number of courts to consider the problem. See *Commissioner* v. *Morgan*, 272 F. 2d 936 (9th Cir. 1959); *Rosen* v. *United States*, 288 F. 2d 658 (3rd Cir. 1961); *United States* v. *Harrison*, 304 F. 2d 835 (5th Cir. 1962), *cert. denied*, 372 U. S. 934 (1963); *Pattiz* v. *United States*, 311 F. 2d 947 (Ct. Cl. 1963). Contra, *Midland-Ross Corp.* v. *United States*, 214 F. Supp. 631 (N. D., Ohio 1963). Thus, in *Jaglom* v. *Commissioner*, 303 F. 2d 847 (2d Cir. 1962), where we also found that a sum which actually represented interest income must be taxed as such, we noted that "before the 1954 Code specifically covered the subject, most courts held that the excess of the amount received at the maturity of a non-interest bearing note or investment certificate issued at a discount over the cost thereof, being in the nature of an interest return on the capital invested, was ordinary income." 303 F. 2d at 849.

Furthermore, we agree with Judge Levet in his conclusion that the explicit provisions for ordinary income treatment in §1232 of the 1954 Code do not require a different result with respect to pre-1954 obligations. The Senate Committee Report on §1232, indeed, evidences a clear congres-

sional intention to clarify—rather than revise—the existing law. Thus, the Report notes that "under §117(f) of present law, when a corporate . . . bond . . . is retired the transaction is treated as a sale or exchange. There is some uncertainty as to the status of proceeds in these transactions, i.e., as capital gain or as interest income where the [fol. 60] bond or other evidence of indebtedness has been issued at a discount. (See I. T. 3486, 1941-2 C. B. p. 76, as compared with *Commissioner* v. *Caulkins*, 144 F. 2d 482). In these cases, *that part of the amount received on a sale or exchange which may represent a partial recovery of discount on original issue is a form of interest income* and in fact is deductible as an interest payment by the issuing corporation. Effective with respect to bonds issued after December 31, 1954, *the House bill removes doubt in this area* by providing that any gain realized by the holder of a bond attributable to the original issue discount will be taxed as ordinary income." 3 U. S. Code Cong. & Ad. News 1954, at 4745. (Emphasis supplied.)

We find, in sum, that both reason and authority support the position adopted by the Commissioner. The taxpayers, however, urge as a final argument that the Commissioner's acquiescence in the *Caulkins* decision at the time it was rendered precludes him from taking a different position in the present case, even if we agree that ordinary income treatment was proper. We find this contention to be entirely without merit. The Supreme Court has noted that "the doctrine of equitable estoppel is not a bar to the correction by the Commissioner of a mistake of law." *Automobile Club of Michigan* v. *Commissioner*, 353 U. S. 180, 183 (1957). It would seem unduly harsh to hold that a mistaken interpretation of law by the Commissioner of Internal Revenue forever bars the United States government from correcting such an error, and subsequently collecting the taxes rightfully due.

The judgment is affirmed.

[fol. 61]

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Present: Hon. Leonard P. Moore, Hon. J. Joseph Smith, Hon. Irving R. Kaufman, Circuit Judges.

W. PALMER DIXON, et al., Plaintiffs-Appellants,

v.

UNITED STATES OF AMERICA, Defendant-Appellee.

JUDGMENT—June 19, 1964

Appeal from the United States District Court for the Southern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

On Consideration Whereof, it is now hereby ordered, adjudged, and decreed that the judgment of said District Court be and it hereby is affirmed.

A. Daniel Fusaro, Clerk.

[fol. 62] [File endorsement omitted]

[fol. 63] Clerk's Certificate to foregoing transcript (omitted in printing).

[fol. 64]

SUPREME COURT OF THE UNITED STATES

No. 486—October Term, 1964

W. PALMER DIXON, et al., Petitioners,

v.

UNITED STATES.

ORDER ALLOWING CERTIORARI—December 14, 1964

The petition herein for a writ of certiorari to the United States Court of Appeals for the Second Circuit is granted, and the case is placed on the summary calendar.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

IN THE

Supreme Court of the United States

October Term, 1964

No. 486

W. PALMER DIXON, JOAN DIXON, EVERETT W. CADY, CLARISSA H. CADY, J. HERBERT HIGGINS, MARION BLAIR HIGGINS, STEPHEN A. KOSHLAND, CAROL F. KOSHLAND, HENRY A. LOEB, JOHN L. LOEB, CARL M. LOEB, JR. and MARGARET L. KEMPNER, as Executors of the Last Will and Testament of CARL M. LOEB, SR., Deceased, HENRY A. LOEB, JOHN L. LOEB, CARL M. LOEB, JR., and ALAN H. KEMPNER, as Executors of the Last Will and Testament of ADELINE M. LOEB, Deceased, JOHN L. LOEB, FRANCES L. LOEB, HENRY A. LOEB, LOUISE S. LOEB, CLIFFORD W. MICHEL, BARBARA R. MICHEL, MARK J. MILLARD, CLAIRE MILLARD, HENRY PARISH, 2ND, DOROTHY PARISH, HUBERT R. A. SIMON, SAMUEL L. STEDMAN and GERDA C. STEDMAN,

Petitioners-~~Appellants~~,

~~HELEN J. GERNON and HELENE G. HIRSON as Executrices of the Last Will and Testament of FRANK E. GERNON, Deceased, HELEN J. GERNON,~~

~~Plaintiffs~~,

against

THE UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BERNARD E. BRANDES,
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Citations

IN THE

Supreme Court of the United States

October Term, 1964

No. ——

W. PALMER DIXON, JOAN DIXON, EVERETT W. CADY, CLARISSA H. CADY, J. HERBERT HIGGINS, MARION BLAIR HIGGINS, STEPHEN A. KOSHLAND, CAROL F. KOSHLAND, HENRY A. LOEB, JOHN L. LOEB, CARL M. LOEB, JR. and MARGARET L. KEMPNER, as Executors of the Last Will and Testament of CARL M. LOEB, SR., Deceased, HENRY A. LOEB, JOHN L. LOEB, CARL M. LOEB, JR., and ALAN H. KEMPNER, as Executors of the Last Will and Testament of ADELINE M. LOEB, Deceased, JOHN L. LOEB, FRANCES L. LOEB, HENRY A. LOEB, LOUISE S. LOEB, CLIFFORD W. MICHEL, BARBARA R. MICHEL, MARK J. MILLARD, CLAIRE MILLARD, HENRY PARISH, 2ND, DOROTHY PARISH, HUBERT R. A. SIMON, SAMUEL L. STEDMAN and GERDA C. STEDMAN,

Petitioners-Appellants,

HELEN J. GERNON and HELENE G. HIRSON as Executrices of the Last Will and Testament of FRANK E. GERNON, Deceased, HELEN J. GERNON,

Plaintiffs,

against

THE UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered on June 19, 1964 in the above entitled case.

Opinions Below

The opinion of the United States Court of Appeals for the Second Circuit is not yet reported but is printed in Appendix A hereto, *infra,* pp. 1a to 7a, to this petition. The opinion of the District Court is reported at 224 F. Supp. 358 and is set forth herein in Appendix A hereto, *infra,* pp. 8a to 21a.

Jurisdiction

The judgment of the United States Court of Appeals for the Second Circuit was entered on June 19, 1964. The jurisdiction of this court is invoked under Title 28 U.S.C. 1254(1).

Questions Presented

1. Whether under the 1939 Internal Revenue Code gain realized on the sale of notes issued at a discount constitutes capital gain or ordinary income in the nature of interest?

2. Where the petitioners relied, in entering into a transaction, upon a Treasury position, evidenced by a published Commissioner's Acquiescence in a decision of the Sixth Circuit (*Commissioner* v. *Caulkins,* 144 F. 2d 482 (C.A. 6th, (1944)) , that original issue discount is, when realized, capital gain, may the Commissioner thereafter change his position retroactively to the detriment of the petitioners, and seek to tax such income as ordinary income in the nature of interest?

Statutes Involved

The relevant sections of the Internal Revenue Code of 1939 are printed in Appendix A, *infra,* pp. 21a to 22a.

Statement of the Case

Petitioners, members of the firm of Carl M. Loeb, Rhoades & Co., a partnership, instituted this action for the refund of income taxes and interest alleged to have been erroneously and illegally assessed and collected by the Government from them for the year 1952.

During the calendar year 1952, the partnership acquired 33 short-term non-interest bearing promissory notes which had been issued at a discount. The notes were purchased, either directly from the issuing obligor corporation or through agents or dealers, on the original date of issue in all but one instance. The notes had been purchased by the

partnership in reliance on the Commissioner of Internal Revenue's interpretation of applicable Sections of the Internal Revenue Code as evidenced by his published Acquiescence in the case of *Commissioner* v. *Caulkins,* 144 F. 2d 482 (C.A. 6th, 1944). In that case the Sixth Circuit held that gain realized upon redemption at maturity of a debt obligation issued at a discount is capital gain.

Immediately upon acquisition, the promissory notes were segregated and identified as held for investment in accordance with Section 117 (n) of the Code. From time to time during the year 1952, the partnership sold some of the promissory notes prior to maturity thereof but which had been held by the partnership for a period in excess of six months.

The partnership reported the difference between the sales price and its cost as long term capital gain from the sale of capital assets, and the partners reported their respective distributive shares of said capital gain and paid the tax thereon. The Commissioner disallowed the petitioner's capital gain treatment on the 1952 sale of their promissory notes, and ruled that the profits were ordinary in the nature of interest. The Commissioner computed the income earned by virtue of the discount for each day that each of the 33 notes were held by the Partnership. This earned discount per day was then multiplied by the number of days that the notes were held, and the resulting amount was held ordinary income in the nature of earned interest, and each partner was held taxable on his distributive share of such ordinary income. The deficiencies were paid by the petitioners, claims for refund were filed and denied, and the petitioners thereafter instituted this action in the District Court.

On cross motions for summary judgment, the issues before the District Court were (1) whether the gain attributable to the original issue discount should, under the 1939 Code, be treated when realized as ordinary income or capital gain and (2) whether in light of the consistent prior

Treasury position as evidenced by the Acquiescence in *Commissioner* v. *Caulkins,* which recognized original issue discount when realized as capital gain, may the Treasury despite petitioners reliance thereon, retroactively change its position to the detriment of petitioners. The District Court granted the Government's motion for summary judgment and dismissed with prejudice the amended complaint of the petitioners. The Court of Appeals affirmed.

Reasons for Granting the Writ

1. The Court below held that gain attributable to original issue discount when realized on the sale of notes issued at a discount constitute ordinary income under the 1939 Code. This decision is in direct conflict with the recent decision of the Sixth Circuit Court of Appeals in *Midland-Ross Corp.* v. *United States,* No. 15,524, decided July 29, 1964, not yet reported, reprinted in Appendix B, *infra,* pp. 23a to 24a. The conflict was recognized in the opinion of the judges of the Sixth Circuit Court of Appeals, *infra,* at p. 24a.

This conflict was also recognized by the Court below, *infra,* at p. 6a, because of the earlier decision by the Sixth Circuit in *Commissioner* v. *Caulkins,* which was followed by that Court in *Midland-Ross Corp.* v. *United States.*

A further conflict has arisen, since the decision below. On July 28, 1964, the Court of Appeals for the First Circuit, passed on the same question, and followed the decision below. *Real Estate Investment Trust of America* v. *Commissioner,* No. 6288, decided July 28, 1964. A direct conflict, thus exists on this question also as between the First Circuit and the Sixth Circuit.

2. Certiorari should be granted because of the importance of the issues.

A. That portion of the decision below relating to the tax treatment of original issue discount under the 1939 Code is of continued importance in the interpretation and administration of the Internal Revenue Code of 1954. Section 1232 (a) (2) (A) of the 1954 Code treats original issue discount realized on the sale of evidence of indebtedness as ordinary income. However, this section is applicable only to evidences of indebtedness issued after December 31, 1954. The tax treatment of debt instruments issued prior to January 1, 1955, if sold prior to maturity, would be determined by the construction of Sections 61, 1001 (a) and 1221, the successors respectively to Section 22 (a), 111 (a) and 117 (a) (1) of the 1939 Internal Revenue Code, and if held to retirement, determined by the construction of Section 1232 (a) (1), the successor to Section 117 (f) of the 1939 Internal Revenue Code.

Petitioners understand that numerous evidences of indebtedness issued at a discount prior to January 1, 1955 have been retired or sold in taxable years which are still open and under review by the Internal Revenue Service. There may also be numerous debt instruments issued at discount prior to January 1, 1955 which are still outstanding; the tax consequence of which remains yet to be determined. Consequently, it is in the public interest that this Court settle the question as to whether realized profit by reason of original issue discount on debt instruments issued prior to January 1, 1955 is ordinary income or capital gain. In the absence of a decision by this court, litigation involving the tax treatment of original issue discount on debt instruments issued prior to January 1, 1955 will continue and the tax treatment of such original issue discount will depend upon where the taxpayer resides.

B. The aspect of the decision below having to do with the Commissioner's retroactive application of his change of position arising from his repudiation of his prior Acquiescence in *Commissioner* v. *Caulkins* is of great import-

ance to the entire business community under any Internal Revenue Code. The Court below held that the Commissioner may in 1955 withdraw his 1944 acquiescence in *Commissioner* v. *Caulkins.* However, the Court below, purporting to follow this Court's decision in *Automobile Club of Michigan* v. *Commissioner,* 353 U. S. 180 (1957), further held that the Commissioner may without regard to the circumstances of the case successfully and at will impose tax consequences arising from the subsequent change of position upon a transaction entered into and consummated in 1952 in reliance upon the Commissioner's then undisturbed Acquiescence. The Court below moreover approved the retroactive application to petitioners of Commissioner's change of position despite the fact that such change had not been uniformly applied to all taxpayers. See Revenue Ruling 56-299, 1956-1 Cum. Bull. 603. This is no different from retroactive and discriminatory taxation and should be repugnant.

The decision below will harm the orderly administration of the tax laws. First, it is unhealthy for administrative law to approve administrative action imposing taxes not foreseeable by taxpayers. The power of the administrative authority thus sanctioned would verge on the purely arbitrary. Second, the decision greatly impedes business planning. Businessmen, and their tax law advisers, do and should be encouraged to, rely on the law as stated in decisions of the Courts in which the Commissioner announces his Acquiescence. Reliance is invited by the very words of the official bulletin in which an Acquiscence is published. Under the decision below, business planners may no longer rely on the Commissioner's Acquiescences. The decision, unless reviewed by this Court, will hinder and frustrate the planning of business transactions both large and small and therefore the productive functioning of the economy.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that this petition for a writ of certiorari be granted.

September 2, 1964.

Respectfully submitted,

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Sanford Saideman,
Attorneys for Petitioners,
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Of Counsel:
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APPENDIX A

(Opinion of Court of Appeals)

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 451—September Term, 1963.

(Argued April 30, 1964 Decided June 19, 1964.)

Docket No. 28752

W. PALMER DIXON, JOAN DIXON, EVERETT W. CADY, CLARISSA H. CADY, J. HERBERT HIGGINS, MARION BLAIR HIGGINS, STEPHEN A. KOSHLAND, HENRY A. LOEB, JOHN L. LOEB, CARL M. LOEB, JR. and MARGARET L. KEMPNER, as Executors of the Last Will and Testament of CARL M. LOEB, SR., Deceased, HENRY A. LOEB, JOHN L. LOEB, CARL M. LOEB, JR., and ALAN H. KEMPNER, as Executors of the Last Will and Testament of ADELINE M. LOEB, Deceased, JOHN L. LOEB, FRANCES L. LOEB, HENRY A. LOEB, LOUISE S. LOEB, CLIFFORD W. MICHEL, BARBARA R. MICHEL, MARK J. MILLARD, CLAIRE MILLARD, HENRY PARISH 2ND, DOROTHY PARISH, HUBERT R. A. SIMON, SAMUEL L. STEDMAN and GERDA C. STEDMAN,

Plaintiffs-Appellants,

HELEN J. GERNON and HELENE G. HIRSON, as Executrices of the Last Will and Testament of FRANK E. GERNON, Deceased, HELEN J. GERNON,

Plaintiffs,

—v.—

THE UNITED STATES OF AMERICA,

Defendant-Appellee.

Before:

MOORE, SMITH and KAUFMAN,
Circuit Judges.

Appeal from a judgment of the United States District Court for the Southern District of New York, LEVET, *J.*, awarding summary judgment to the United States in an action for the refund of income taxes paid. 224 F. Supp. 358 (S. D. N. Y. 1963).

Affirmed.

BERNARD E. BRANDES, of Stroock & Stroock & Lavan, New York, N. Y. (Sanford Saideman, of counsel), *for plaintiffs-appellants.*

ROBERT ARUM, Assistant United States Attorney for the Southern District of New York, New York, N. Y. (Robert M. Morgenthau, United States Attorney, of counsel), *for defendant-appellee.*

KAUFMAN, *Circuit Judge:*

The sole question presented by this appeal is whether profits attributable to original issue discount on "commercial paper," defined as short-term, non-interest-bearing commercial obligations, are taxable at ordinary income or capital gains rates under the Internal Revenue Code of 1939.[1]

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[1] Unlike the 1954 Code, see *infra*, the Internal Revenue Code of 1939 did not contain any specific provisions with respect to original issue discount. The relevant statutory sections, therefore, are merely § 22, which included "interest" in its general definition of "gross income," and § 117, which provided for capital gains treatment upon the sale or exchange of a "capital asset."

The relevant facts in this case are the free from dispute. Thus, the plaintiff's amended complaint reveals that during the taxable year 1952, the taxpayers or their spouses or decedents were partners in the investment firm of Carl M. Loeb Rhoades & Co., a member of the New York and American Stock Exchanges. At various times during the year, the partnership purchased thirty-three short-term, non-interest-bearing notes, either directly from the obligor corporation, or through agents or dealers. The notes bore maturity dates ranging from 190 to 272 days from the date of issue, and all were issued at discounts, which varied between 2⅜% and 3¾% of face value. At the close of the taxable year, only thirteen notes remained on hand and unmatured; the remaining twenty had been sold during the year—all more than six months after they had been purchased.

In preparing their income tax returns for 1952, each partner reported as a long-term capital gain his distributive share of the profits realized upon twenty notes that had been sold, and no account was taken of the thirteen which remained on hand. Rejecting these computations, the Commissioner determined deficiencies totalling some $369,-329.65. In place of the taxpayers' method of analysis, he computed the income earned by virtue of the discount for each day that each of the thirty-three notes were held by the partnership. This earned discount per day was then multiplied by the number of days that the notes were held, and the resulting amount was considered as earned interest, and afforded ordinary income treatment. Having paid the deficiencies assessed, the taxpayers brought this action for a refund.

On cross-motions for summary judgment below, Judge Levet found that the Commissioner had properly interpreted the relevant provisions of the 1939 Code, in viewing the profit derived from the discount as equivalent to interest

income, and accordingly taxing it at ordinary income rates. Although recognizing that § 1232 of the Internal Revenue Code of 1954 specifically provides for ordinary-income treatment in original issue discount situations, he concluded that this section was merely intended to clarify the existing law, rather than representing an abrupt departure from the earlier practice. As a result, Judge Levet awarded judgment to the Commissioner, and the taxpayers have brought this appeal.

We should note at the outset that a narrow issue is presented for our decision. It is the taxpayers' contention that the original issue discount resulted in a long-term capital gain, which could only be realized on the twenty notes which were sold; the Commissioner, on the other hand, asserts that the discount produced interest income which must properly be computed for the period that all of the notes were held by the partnership. This dispute as to whether capital gains or ordinary income treatment was appropriate, moreover, is the only issue that divides the parties. Thus, no question has been raised as to the propriety of taxing the individual partners for notes held by the partnership, and the taxpayers have conceded that if the discount *did* represent ordinary income, that income was realized upon each of the thirty-three notes held, and was not dependent upon a sale.

Turning, then, to the single question in dispute, we find the approach adopted by the Commissioner and upheld below to be plainly correct. Indeed, unless form rather than substance is to carry the day, such a conclusion seems inescapable in light of the facts here conceded. Thus, we are aware of no meaningful distinction, and the taxpayers have offered none, between the discount income involved here and the more traditional forms of "interest on indebtedness," defined in *Deputy* v. *duPont*, 308 U. S. 488, 498 (1940), as "compensation for the use or forbearance of

money." Whatever superficial or mechanical differences in form, both are designed to accomplish the same objective—the production of income for "the hire of money." And this factual identity between discount income, as employed here, and interest income seems both crucial and apparent. In the terms of an illustration offered by the Commissioner, there should be no distinction for tax purposes between a case in which \$10,000 is advanced by a lender in exchange for a \$10,000 note, payable in one year with interest at 6%, and the original issue discount situation, in which the same \$10,000 would be loaned in exchange for a note in the face amount of \$10,600. When these transactions are reduced to their essentials, it becomes plain that in both cases, the lender has advanced \$10,000, and has received that amount in return, plus \$600 in interest. It would seem arbitrary to insist, as do the taxpayers, that significant tax consequences should hinge upon whether this \$600 sum is separately stated as interest or is included in the face amount of the note. It has been repeatedly emphasized that our taxing statutes are intended to take cognizance of realities and not mere appearances or facades. See, e.g., *Commissioner* v. *P. G. Lake, Inc.*, 356 U. S. 260, 266-67 (1958).

Without denying the force of this reasoning, the taxpayers argue, however, that capital gains treatment is compelled by the decision in *Caulkins* v. *Commissioner*, 144 F. 2d 482 (6th Cir. 1944). The taxpayer there paid some \$15,043.33 over a ten-year period for an "accumulated installment certificate" which returned him \$20,000 when the certificate was redeemed. Although recognizing that the certificate was an "evidence of indebtedness" and that the increment in value represented "consideration paid for the use of the amounts paid in," the Court of Appeals for the Sixth Circuit held that the difference between the amount paid and the sum received on redemption was taxable as a long-term capital gain.

We are willing to agree for present purposes that the notes involved here are analogous to the certificate at issue in *Caulkins*. But in light of our conclusion that original issue discount income is indistinguishable from interest income, we are of the opinion that the *Caulkins* case was wrongly decided. In so holding, we find ourselves in agreement with the greater number of courts to consider the problem. See *Commissioner* v. *Morgan*, 272 F. 2d 936 (9th Cir. 1959); *Rosen* v. *United States*, 288 F. 2d 658 (3rd Cir. 1961); *United States* v. *Harrison*, 304 F. 2d 835 (5th Cir. 1962), *cert. denied*, 372 U. S. 934 (1963); *Pattiz* v. *United States*, 311 F. 2d 947 (Ct. Cl. 1963). Contra, *Midland-Ross Corp.* v. *United States*, 214 F. Supp. 631 (N. D., Ohio 1963). Thus, in *Jaglom* v. *Commissioner*, 303 F. 2d 847 (2d Cir. 1962), where we also found that a sum which actually represented interest income must be taxed as such, we noted that "before the 1954 Code specifically covered the subject, most courts held that the excess of the amount received at the maturity of a non-interest bearing note or investment certificate issued at a discount over the cost thereof, being in the nature of an interest return on the capital invested, was ordinary income." 303 F. 2d at 849.

Furthermore, we agree with Judge Levet in his conclusion that the explicit provisions for ordinary income treatment in §1232 of the 1954 Code do not require a different result with respect to pre-1954 obligations. The Senate Committee Report on §1232, indeed, evidences a clear congressional intention to clarify—rather than revise—the existing law. Thus, the Report notes that "under §117(f) of present law, when a corporate . . . bond . . . is retired the transaction is treated as a sale or exchange. There is some uncertainty as to the status of proceeds in these transactions, i.e., as capital gain or as interest income where the bond or other evidence of indebtedness has been issued at a discount. (See I. T. 3486, 1941-2 C. B. p. 76, as com-

pared with *Commissioner* v. *Caulkins,* 144 F. 2d 482). In these cases, *that part of the amount received on a sale or exchange which may represent a partial recovery of discount on original issue is a form of interest income* and in fact is deductible as an interest payment by the issuing corporation. Effective with respect to bonds issued after December 31, 1954, *the House bill removes doubt in this area* by providing that any gain realized by the holder of a bond attributable to the original issue discount will be taxed as ordinary income." 3 U. S. Code Cong. & Ad. News 1954, at 4745. (Emphasis supplied.)

We find in sum, that both reason and authority support the position adopted by the Commissioner. The taxpayers, however, urge as a final argument that the Commissioner's acquiescence in the *Caulkins* decision at the time it was rendered precludes him from taking a different position in the present case, even if we agree that ordinary income treatment was proper. We find this contention to be entirely without merit. The Supreme Court has noted that "the doctrine of equitable estoppel is not a bar to the correction by the Commissioner of a mistake of law." *Automobile Club of Michigan* v. *Commissioner,* 353 U. S. 180, 183 (1957). It would seem unduly harsh to hold that a mistaken interpretation of law by the Commissioner of Internal Revenue forever bars the United States government from correcting such an error, and subsequently collecting the taxes rightfully due.

The judgment is affirmed.

Opinion of Levet, *D. J.*

(Tr. pp. 223-238)

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

LEVET, *D. J.*:

These are cross-motions for summary judgment in an action for refund of federal income taxes paid by the plaintiffs for the taxable year 1952 in the sum of $369,329.65 plus interest. Jurisdiction is based upon 28 USC §1346(a). The parties agree, except for one fact, which will be dealt with later, that there are no issues as to any material facts.

The facts surrounding this claim for refund are as follows.

During the year 1952, the plaintiffs were partners in the investment firm of Carl M. Loeb Rhoades & Co. (hereinafter "partnership"), a member of the New York and American Stock Exchanges. The principal sources of income of the partnership are from commissions earned on sales of customers' securities, the underwriting and selling of securities and from trading and investing on its own account.

During 1952, the partnership acquired 33 short-term non-interest bearing notes, commonly known as commercial paper. All of the notes were issued at a discount which ranged from 2⅜ to 3¾% on the face value of the notes. The notes were purchased either directly from the issuing obligor corporation or through agents or dealers on the original date of issue. The notes had maturity dates between 190 and 272 days from the date of issue. All of these notes were either sold subsequent to six months after their purchase or were retained, unmatured, at the close of the taxable year 1952.

Plaintiffs reported the distributive share of the profit realized from the sale by the partnership of 20 of the notes during the year 1952 as long-term capital gain. The Inter-

nal Revenue Service disallowed capital gain treatment and computed the discount earned per day for each note by dividing the number of days between issuance and maturity into the total discount. The earned discount per day, multiplied by the number of days the notes were held during 1952, either before sale or as of December 31, was considered as "discount earned." The Internal Revenue Service treated the amount of "discount earned" as ordinary income. Deficiencies were assessed against the plaintiffs. The deficiencies were paid, a claim for refund was duly filed, and this action was thereafter commenced.

The parties differ as to the treatment which should be accorded to the original issue discounts. The plaintiffs claim that the amounts so realized are long-term capital gains, while the Internal Revenue Service held them to be interest, therefore, ordinary income. In addition, the plaintiffs urge the Commissioner of Internal Revenue's prior acquiescence in 1944 in the case of *Commissioner v. Caulkins,* 144 F. 2d 482 (6 Cir. 1944), affirming 1 T. C. 656 (1943), estops the Internal Revenue Service from now claiming that original issue discounts should be treated as interest since they relied on the Caulkins' acquiescence when they purchased the securities in 1952.

Thus, the issue is squarely before the court: Aside from any consideration of reliance or estoppel, when short-term non-interest bearing notes are purchased at a discount, is the amount of such discount when realized in the nature of interest or a capital gain?

Discussion

A. Statutes Involved

There are two sections of the Internal Revenue Code of 1939 which must be considered in determining this action. They are Sections 22 and 117 (a) (1). Section 22 provides:

"§ 22. Gross income

"(a) General definition. 'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *"

Section 117 (a) (1) provides:

"§ 117. Capital gains and losses

"(a) Definitions As used in this chapter—

"(1) Capital assets. The term 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

"(A) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

"(B) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1), or real property used in his trade or business;

"(C) * * *

"(D) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest [sic] at a fixed maturity date not exceeding one year from the date of issue."

B. Does the 1939 Code Allow Original Issue Discounts to Be Treated as Capital Gains?

The plaintiffs rely heavily upon the case of George Peck Caulkins, supra. The Caulkins case involved a taxpayer who paid $15,043.33 over a ten-year period for an accumulated installment certificate which returned him $20,000 at the end of the ten years when the certificate was redeemed. The Tax Court and the Circuit Court of Appeals for the Sixth Circuit held that the difference between the amount paid and the amount received by the taxpayer upon redemption was a long-term capital gain. This result was achieved primarily through a peculiar application of Section 117 (f), which provided:

"(f) Retirement of bonds, etc. For the purposes of this chapter, amounts received by the holder upon the retirement of bonds, debentures, notes, or ceritficates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor."

The two courts were of the opinion that $4,956.67 increment received by the taxpayer was a capital gain because Section 117(f) makes the amounts received by the holder on retirement of a certificate or other evidence of indebtedness capital gains. Therefore, on the basis of the Caulkins

case, the plaintiffs urge that the increment as a result of an original issue discount on a note sold before maturity would result in a capital gain and not ordinary income.

C. The Caulkins Case Was Wrongly Decided.

It is clear that the Courts in the Caulkins case wrongly interpreted the purpose and scope of Section 117(f). The situation which gave rise to the enactment of Section 117(f) is illustrated by the case of Fairbanks v. United States, 306 U. S. 436 (1939). There, the taxpayer acquired bonds at less than par value. The court held that the increment received upon the retirement of the bonds could not be considered as capital gains because the redemption of the bonds was not a "sale or exchange thereof" and the statute defined a capital gain as meaning "taxable gain from the sale or exchange of capital assets." Following the Fairbanks case Section 117(f) was enacted.

It seems plain that Section 117(f) was not designed to accomplish any other purpose but to reverse the type of result achieved in the Fairbanks case. Nowhere in the text of Section 117(f) or in its legislative history is there any indication that if, upon retirement of such bonds, the increment a taxpayer receives would be converted into capital assets or treated as capital gains.

The literal language of Section 117(f) if applied to facts identical to those in the Caulkins case, supra, yields only one conclusion, the increment should be treated as ordinary income. The operative words of Section 117(f) are: "Amounts received by the holder upon retirement * * * shall be considered as amounts in exchange therefor." In a Caulkins-type fact situation, we have a combination of both a capital asset (the notes or other evidence of indebtedness) and the interest on other earnings from that asset. The courts in Caulkins failed to realize that the gain realized from the deemed sale of a capital asset which

has appreciated in value is capital gain, whereas, gain realized by income from the capital asset is ordinary income. The court, in other words, considered both the capital asset and the increment by way of interest or discount together and considered the combined amount as a capital gain.

The rationale of the Caulkins case has been repudiated in recent years by other courts which had cases similar to Caulkins. See Commissioner v. Morgan, 272 F. 2d 936 (9 Cir. 1959); Rosen v. United States, 288 F. 2d 658 (3 Cir. 1961); United States v. Harrison, 304 F. 2d 835 (5 Cir. 1962), cert. denied 372 U. S. 934 (1963); Pattiz v. Commissioner, 311 F. 2d 947 (Ct. Cl. 1963); Richard B. Gibbons, 37 T. C. 569 (1961); V. David Leavin, 37 T. C. 766 (1962).

The Plaintiffs' Claim of Reliance Upon The Caulkins Acquiescence

The plaintiffs claim that they relied on the Caulkins case and the acquiescence in Caulkins by the Treasury Department when they entered into these transactions in 1952. Since Caulkins has been repudiated by the Commissioner, the plaintiffs contend that to apply this change of position to them would cause them substantial injury.

The law is clear that the Commissioner of Internal Revenue can retroactively correct a mistake of law even where a taxpayer has relied on the previous determination to his detriment. Manhattan General Equipment Co. v. Commissioner, 297 U. S. 129 (1936); Helvering v. Reynolds, 313 U. S. 428 (1941); Automobile Club of Michigan v. Commissioner, 353 U. S. 180 (1957); 10 Mertens, Law of Federal Income Taxation § 60.16 (Zimet Rev. 1958). Therefore, it is clear that plaintiffs' alleged reliance, even if proved, does not estop the Commissioner from apply-

ing the correct legal principles in determining the income of the partnership. Therefore, we deem it unnecessary to pass upon this claim of reliance.

Assuming, arguendo, that the law would allow the claim of reliance, this court cannot agree with the plaintiffs that they have any ground to base their reliance upon the Caulkins decision and the acquiescence by the Commissioner. A thorough examination of the prior Treasury Department rulings demonstrates that the result reached in Caulkins was an exception to the general policy of the Internal Revenue Service to treat amounts received by original issue discount as income. Also, the prior rulings demonstrate that Caulkins is distinguishable from the present claim on the law and on its facts.

In 1940, G. C. M. 21890, 1940-1 Cum. Bull. 85 was issued. There, the Commissioner held that the amount of an original issue discount upon a state obligation was in the nature of deferred interest, therefore, non-taxable income to the taxpayer under Section 22(b)(4) of the Revenue Act of 1938, which provided for the exclusion from gross income and exempted from taxation interest upon state obligations.

In 1941, I. T. 3486, 1941-2 Cum. Bull. 76 was published. It provided that since the Public Debt Act of 1941 provided that the interest upon, and gain from sale or other disposition of, United States Treasury Bills issued on or after March 1, 1941 are no longer tax exempt, the amount of discount "* * * is includible in gross income as interest * * *".

After Caulkins was affirmed by the Sixth Circuit, the Treasury Department acquiesced in its result. (See list of acquiescences in 1944 Cum. Bull.)

In 1953, the Commissioner published Rev. Rul. 119, 1953-2 Cum. Bull. 95. Rev. Ruling 119 provided:

"What included in gross income

"The discount at which a 'Twelve Year Dollar Savings Bond' of the State of Israel is originally issued constitutes interest which is taxable as ordinary income under section 22(a) of the Internal Revenue Code when realized upon redemption; it does not represent an amount received upon retirement of the bond within the meaning of section 117(f) of the Code.

* * *

"Since about 1920, discount realized on retirement of State and municipal obligations in the hands of the original purchaser has been treated by the Bureau as interest, the theory being that the discount is an amount paid in lieu of interest. * * * The position taken by the Bureau * * * has been consistently maintained with regard to characterizing discount as interest and treating the excess over discount (and ordinary interest, if any) realized upon retirement as taxable income. However, after the enactment of section 117(f) of the Internal Revenue Code, the excess over discount has been consistently taxed as capital gain rather than ordinary gain (See G. C.M. 21890, C.B. 1940—1,85) Therefore, only the excess of the amount realized from a State or municipal bond, less discount from the date of acquisition, and ordinary interest, if any, over the cost or other basis of the bond is the amount received upon retirement taxable as capital gain under section 117(f) of the Code.

* * *

"In the case of Commissioner v. George Peck Caulkins, 144 Fed. (2d) 482, affirming Tax Court decision, 1 T.C. 656, acquiescence, C.B. 1944, 5, the Court held that the excess of the amount received by the taxpayer, pursuant to a contract with In-

vestors Syndicate over the aggregate payments made by him for an Accumulative Installment Certificate, constituted capital gain and stated that the certificate in question ' "was an evidence of indebtedness" similar to a bond or debenture and hence falls within the statutory group governed by section 117(f).' The decision should be limited precisely to what was there decided under the particular facts of that case. It would be inappropriate to apply the decision to any other case unless the facts and circumstances conform to those stated in the published decision of the Tax Court in the Caulkins case."

In 1955, Revenue Ruling 55-136, 1955-1 Cum. Bull. 213 was published. It provided:

> "Section 117(f) of the Internal Revenue Code of 1939 applies only to amounts received by reason of redemption of bonds. It does not apply to the amount of interest (whether paid in the form of discount or not) which is received by reason of holding the bond. Such interest-equivalent payments are taxable as ordinary income under section 22(a) of the code.
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> * * *
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> "It has been the policy of the Internal Revenue Service to restrict the application of the Caulkins case to cases involving the identical facts. This position has been reconsidered in the light of Revenue Ruling 119, supra, i.e., that the amount received upon the redemption of a bond which represents original or initial discount constitutes interest which is taxable as ordinary income. There is no logical basis in fact or in law to distinguish the discount element in the Accumulative Installment Certificate involved in the Caulkins case from the original dis-

count element involved ordinarily in the issuance of any bonds."

It is clear that Caulkins was an exception to the rule that amounts received from original issue discounts were treated as ordinary income. In order for the plaintiffs to rely on Caulkins it is also clear that their claim must fall into the identical exception Caulkins created. Caulkins involved a peculiar application of Section 117(f), Internal Revenue Code of 1939, to redemption of "Accumulative Installment Certificates." Here, Section 117(f) does not apply since we have a sale before maturity and not a redemption. Therefore, the exception created by Caulkins is not precedent for the claim of plaintiffs.

In Midland-Ross Corp. v. United States, 214 F. Supp. 631 (N.D. Ohio 1963), cited by the plaintiffs, the court rejected the distinction between the tax consequences of a sale and that of a redemption. The court stated, 214 F. Supp. at 631: "The combination of the Caulkins case with Section 117(f) thus indicates that appreciation realized on evidences of indebtedness, issued at an original issue discount and sold before maturity, constituted a capital gain and not regular income. The remaining question, therefore, is whether the legislative, administrative and judicial treatments of discount obligations support this indication." The court concluded "* * * while it is true that the recent cases have adopted the Government's position, they have done so (1) without a discussion of the historical treatment of gains resulting from original issue discount, and (2) only upon a rejection of the Caulkins case, which is controlling in this Circuit."

I cannot agree with the court in Midland-Ross, supra, that the legislative, judicial and administrative treatments support the conclusion that increments by way of original issue discounts on bonds sold before maturity must be

treated as capital gains. Moreover, the Caulkins case does not support the court's conclusion for two reasons. First, on its facts it was wrongly decided; second, assuming Caulkins was correct, it provides no precedent for cases concerning the sale before maturity of original issue discount bonds.

In sum, it is clear that (1) Caulkins was wrongly decided; (2) even assuming Caulkins had been correctly decided, it provides no precedent for the plaintiffs; and (3) the plaintiffs cannot estop the government on the basis of the Caulkins acquiescence.

The plaintiffs' claim for refund is narrowed to a single question: What is the tax treatment accorded to increments received from short-term, non-interest bearing notes issued at a discount? The answer is clear; that portion of any profit realized upon a subsequent sale of the notes which is attributable to the discount as well as any discount earned upon unsold notes is taxable as ordinary income and not capital gain.

Substance, reality and total effect of a particular transaction will determine the tax consequences thereof. Commissioner v. P. G. Lake Inc., 356 U. S. 260, 266 (1957). The forms or method of accounting for a transaction do not control, since "Their essence is determined not by the subtleties of draftsmanship but by their total effect. See Helvering v. Clifford, 309 U. S. 331; Harrison v. Schaffner, 312 U. S. 579." 356 U. S. at 266-67. In other words: "The law is not to be hoodwinked by colorable pretenses. It looks at truth and reality, through whatever disguise it may assume." Commonwealth v. Hunt, 45 Mass. 111, 129 (1842).

The "total effect" of the transactions which the partnership entered into makes it clear that the partnership earned interest, ordinary income as a result of these discounts. The term "interest," as contained in the "gross

income" definition contained in Section 22(a), Int. Rev. Code of 1939, is defined as the amount which one has contracted to pay for the use of borrowed money. Old Colony Railroad Co. v. Commissioner, 284 U. S. 552, 560 (1932); Commissioner v. Morgan, 272 F. 2d 936, 939 (9 Cir. 1939); Jaglom v. Commissioner, 303 F. 2d 847, 850 (2 Cir. 1962). Although it is true that there may be some valid distinctions between interest and discounts, these distinctions are of little significance. A discount is in the nature of deferred interest which may be amortized, for income tax purposes, over the life of the bonds. The Internal Revenue Service in computing the plaintiffs' tax liability did properly accrue their interest ratably over the period it was earned. 2 Mertens, Law of Federal Income Taxation, § 12.95, p. 276 (Zimet Rev. 1958); Continental Tie & Lumber Co. v. United States, 286 U. S. 290 (1932); United States v. Anderson 269 U. S. 422 (1926).

The plaintiffs contend that the enactment of Section 1232, Int. Rev. Code of 1954, which treats increments from discounts as ordinary income, did effect a change in the laws governing the tax treatment of original issue discounts. This contention is without merit. As stated in Commissioner v. Morgan, 272 F. 2d 936, 941 (9 Cir. 1959):

> "* * * Respondents argue that by making this new provision for bonds issued in the future, Congress recognized that it effected a change and thereby recognized that the law previously was settled by the Caulkins decision. We think not. The Senate Report which accompanied the legislation (S. Rep. No. 1622, 83d Cong., 2d Sess. p. 112; 3 U. S. C. Cong. & Adm. News 1954, 4621, 4745), noted that there was 'some uncertainty as to the status of proceeds in these transactions. * * * The House bill removes doubt in this area.' We find here no evidence that the new enactment did any more than that."

The plaintiffs also contend that even if the original issue discount is taxable as ordinary income, the Internal Revenue Service erroneously accrued the income from the notes not sold by the partnership during the taxable year 1952. While the plaintiffs concede the partnership was on the accrual basis, they assert that the notes were really individual investments of the taxpayers and not the property of the partnership and, hence, interest may not be accrued since the partner taxpayers were on the cash basis. The taxpayers state that there is an issue of fact as to the method of accounting utilized in these investments since they state they used a cash rather than accrual basis. Therefore, they contend that none of the proceeds from the notes that were not sold or redeemed in 1952 should be included in the computation of the 1952 income of the partners.

The claim for refund as well as the complaint filed herein (paragraphs 17(e) and (f) allege that the securities were partnership property. There is no doubt that the partnership tax return was computed on the accrual basis in 1952. Therefore, the unsupported allegation in plaintiffs' statement pursuant to Rule 9(g) of the General Rules of the United States District Court for the Southern District of New York to the effect there remains a genuine issue of fact as to the method of accounting will not prevent the grant of complete summary judgment to the government. As Rule 56, Fed. R. Civ. P. makes clear: "When a motion for summary judgment is made and supported as provided in this rule, an adverse party may not rest upon mere allegations or denials of his pleadings, but his response, by affidavits or as otherwise provided in this rule, must set forth specific facts showing that there is a genuine issue for trial." This the plaintiffs have not done. Since this is a refund action the plaintiffs must not only demonstrate that the Commissioner's method of computation is wrong but also must establish the actual and precise method of

computation which should have been utilized. Taylor v. Commissioner, 70 F. 2d 619, 620-21 (2 Cir.), aff'd 293 U. S. 507 (1935); Alvary v. United States, 302 F. 2d 90 (2 Cir. 1962).

Accordingly, the plaintiff's motion for summary judgment is denied and the defendant's motion for summary judgment is granted with costs.

Settle judgment on notice.

Dated: New York, N. Y.
November 1, 1963

RICHARD H. LEVET,
United States District Judge.

(Statutes Involved)

Sec. 111. Determination of Amount of, and Recognition of, Gain or Loss.

(a) Computation of Gain or Loss.—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in Section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized. (26 U.S.C. 1952 ed., Sec. 111)

Sec. 117. Capital Gains and Losses.

(a) Definitions—As used in this chapter—

(1) Capital Assets.—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

Statutes Involved

* * *

(D) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

* * *

(2) Short-Term Capital Gain.—The term "short-term capital gain" means gain from the sale or exchange of a capital asset held for not more than 6 months, if and to the extent such gain is taken into account in computing gross income;

* * *

(4) Long-Term Capital Gain.—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing net income;

* * *

(f) Retirement of Bonds, etc.—For the purpose of this chapter, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor.

(26 U. S. C. 1952 ed., Sec. 117)

APPENDIX B

(Conflicting Opinions)

No. 15524

UNITED STATES COURT OF APPEALS

FOR THE SIXTH CIRCUIT

MIDLAND-ROSS CORPORATION, *Plaintiff-Appellee,* v. UNITED STATES OF AMERICA, *Defendant-Appellant.*	ON APPEAL from the United States District Court, Northern District of Ohio, Eastern Division.

Decided July 29, 1964.

Before: WEICK, Chief Judge, CECIL, Circuit Judge, and McALLISTER, Senior Circuit Judge.

PER CURIAM. This cause is before the Court on appeal from a judgment of the United States District Court for the Northern District of Ohio granting judgment in favor of the appellee, a taxpayer, against the United States, the appellant. The sole question presented on the appeal is whether original discount income received upon the sale of notes prior to their maturity is entitled to be treated as

capital gains under Section 117(f) of the Internal Revenue Code of 1939.

Judge Kalbfleisch of the District Court wrote a comprehensive opinion in the case in which he followed the ruling of this Court in *Commissioner of Internal Revenue* v. *Caulkins*, 144 F. 2d 482. While some courts [1] have taken a contrary view on the issue presented we are of the opinion that the *Caulkins* case, controlling in our circuit, was correctly decided.

The pertinent facts are stated in the opinion of the District Court reported at *Midland-Ross Corp.* v. *United States*, 214 F. Supp. 631. We agree with the opinion of Judge Kalbfleisch and the judgment of the District Court is affirmed.

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[1] *Dixon* v. *United States*, — F. 2d —, C.A. 2; *Pattitz* v. *United States*, 311 F. 2d 947, Ct. Cl.; *United States* v. *Harrison*, 304 F. 2d 835, C.A. 5, cert. den., 372 U.S. 934; *Rosen* v. *United States*, 288 F. 2d 658, C.A. 3; *Commissioner* v. *Morgan*, 272 F. 2d 936, C.A. 9.

Appendix B—Conflicting Opinions

UNITED STATES DISTRICT COURT

N. D. Ohio, E. D.

Civ. A. No. 36611.

March 11, 1963.

Midland-Ross Corporation,

Plaintiff,

v.

United States of America,

Defendant.

Kalbfleisch, *District Judge.*

This is a suit to recover income and excess profits taxes for the years 1952, 1953 and 1954. The taxpayer is the Midland-Ross Corporation, successor in interest to the Industrial Rayon Corporation. During the period in question, for the purpose of temporarily investing funds not then currently required for its operation, the taxpayer purchased thirteen notes, the face amounts of which varied from $500,000 to $2,000,000. These notes bore no interest, but rather were purchased at a discount by the taxpayer from the maker. Each of the notes was a time instrument.

Before maturity each note was sold to a financial institution at a price which was in excess of the price which had been paid to the maker but below the face amount.

The price paid by the taxpayer to the maker of each note was calculated by subtracting from the face amount a figure determined by multiplying the face amount by an agreed percentage, dividing the product by 360, and multiplying the result by the number of days from the date of such payment to the maturity of the note. The agreed percentage was determined on the basis of the considera-

tion of several factors, including (1) the prevailing interest rates for notes of such duration made by borrowers with credit standings of the obligor, (2) the availability of such notes to prospective purchasers, and (3) the maker's need for cash funds. All of the notes were capital assets in the hands of the taxpayer and were sold by it in bona fide sales. In negotiating the sale price of the notes, the following factors were considered: (1) the face amounts of the obligations, (2) the credit rating of the obligor, (3) the period of time between the sale and the maturity of the notes, (4) the prevailing interest rates, and (5) the amount of cash funds available to the purchaser.

In this three-year period the taxpayer realized a total appreciation of more than $280,000 on these notes. It contended that this appreciation was a capital gain, while the Internal Revenue Service contended that it was regular income. The taxpayer paid taxes at the regular income rate, and is here seeking a refund.

The relevant sections of the Internal Revenue Code are: Section 117(a) (1) (2) and (4) and Section 111(a) of the 1939 Code, and their counterparts in the Code of 1954.

Section 117(a) (1) of the 1939 Code defines a capital asset as:

> "* * * property held by the taxpayer (whether or not connected with his trade or business), but does not include * * *
>
> "(D) an obligation of the United States or of any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue."

Subsections (2) and (4) of Section 117(a) provide that a capital gain is a gain from the sale of a capital asset,

and Section 111(a) provides that the gain from the disposition of property is the "excess of the amount realized therefrom over the adjusted basis * * *."

Plaintiff stresses the fact that the language of the statute, especially of Section 117(a) (1) defining a capital asset, is broad and sweeping. It contends that because these notes were capital assets the gain realized thereon was a capital gain. It contends, further, that in view of Section 117(a) (1) (D), which specifically excludes certain types of discount paper from the category of capital assets, and in view of the failure to exclude such paper as these notes, the Congress clearly indicated its intention that the gain achieved on the sale of such notes constitutes capital gain under the maxim of *expressio unius est exclusio alterius.*

[1] The taxpayer's contention is a familiar enough general rule of statutory construction. However, various courts have read certain exceptions into this statute. They have held that, while it might appear that a literal construction of the statutory language would convert all but the specifically excluded gains into capital gains, the provisions must be construed in the light of their general purpose and the surrounding law. After so doing, these courts have read further exceptions into the statute, which have resulted in the exclusion from capital gains treatment of certain increments which a literal interpretation might indicate were capital gains. See, for example, *Jaglom* v. *Commissioner,* 303 F. 2d 847 (2nd Cir., 1962); *United States* v. *Harrison,* 304 F. 2d 835 (5th Cir., 1962). In view of the fact that these statutory sections have not been interpreted to include all of the transactions which the sweeping scope of their language might indicate were within their purview, the Court is constrained to hold that this argument is not dispositive of the case.

Appendix B—Conflicting Opinions

The Government contends that the realized increment was in fact interest paid for the use of money, and was therefore regular income to the taxpayer. It contends that this is but another instance for application of the well recognized rule that when a taxpayer combines the sale of a right to receive ordinary income with the sale of a capital asset the ordinary income is not converted into a capital gain by its sale in combination with the capital asset. *Fisher* v. *Commissioner,* 209 F. 2d 513 (6th Cir., 1954), cert. den. 347 U. S. 1014, 74 S. Ct. 868, 98 L. Ed. 1136; *Commissioner* v. *Morgan,* 272 F. 2d 936 (9th Cir., 1959); *Rosen* v. *United States,* 288 F. 2d 658 (3rd Cir., 1961); *United States* v. *Harrison,* 304 F. 2d 835 (5th Cir., 1962); and *United States* v. *Langston,* 308 F. 2d 729 (5th Cir., 1962).

The taxpayer does not dispute the general validity of this proposition. Its principal contention, however, is that the rule is inapplicable on these facts because the increment, for purposes of taxation at least, was not interest. It fully admits that if these notes had borne interest at a stated rate, and if it had then sold such notes before maturity at an increase in price, the amount of such increase allocable to the proportion of the interest earned to the date of sale would have been regular income under the rule of *Fisher* v. *Commissioner* and the other cases cited, *supra.* However, it contends that a different result is achieved when, instead of the notes bearing interest at a fixed rate, they were originally sold at a discount. The taxpayer urges that there has been a continuous history of legislative, administrative and judicial interpretation since 1920 which has consistently held that original issue discount in the hands of a cash basis taxpayer is not income, and that the appreciation resulting therefrom is not taxed as regular income but, rather, as a capital gain.

[2] If it is true that historically the law has not considered such original issue discount as interest, but has

removed it from the broad category of regular income and placed it within the specific classification of capital gain, then the increment in this case was not income and the general rule upon which the Government relies is inapplicable. The Court, therefore, must proceed to examine the treatment which such discount has traditionally received.

Commissioner v. *Caulkins*, 144 F. 2d 482 (6th Cir., 1944) is the primary cornerstone upon which the taxpayer rests its contention that the increment here involved was not, for taxation purposes at least, compensation for the use of its money. In that case the taxpayer had purchased an accumulative installment certificate under the terms of which he was to make periodic payments to the seller, who, at the end of ten years, would pay to the taxpayer the sum of $20,000. This $20,000 was approximately $4,900 more than the total amount of the payments made to the seller. The Commissioner contended that this $4,900 was compensation for the use of the taxpayer's money, and was thus really interest. He held that this interest was regular income, although the taxpayer contended it was a capital gain.

The certificate involved in the *Caulkins* case was in registered form and the decision was based upon an interpretation of Section 117(f) of the Internal Revenue Code of 1939. Section 117(f) provided that amounts received by the holder of registered securities upon their retirement should be considered as amounts received in exchange therefor. The Court held that although the $4,900, at least in many respects, was similar to interest, it was an amount which was received in exchange for the sale of a capital asset and was therefore a capital gain.

To understand the *Caulkins* decision it is necessary to understand the history of Section 117(f). Before the enactment of that section it had been held that retirement of a bond was not such a sale or exchange as would qualify the amount received upon the retirement for capital gains

treatment. See *Fairbanks* v. *United States,* 306 U. S. 436, 59 S. Ct. 607, 83 L. Ed. 855 (1939). Section 117(f) was enacted to avoid this holding. It provided that amounts received upon the retirement of certain evidences of indebtedness which had interest coupons attached, or which were in registered form, should be considered as amounts received in exchange therefor. This provision enabled the amounts received upon the retirement of such bonds to qualify as capital gains. The taxpayer contends that this provision was enacted to accord the same tax treatment to such bonds upon their retirement as always had been accorded them on a sale before retirement. And, according to Mertens Law of Federal Income Tax, Volume 38, page 368, M 82:

> "The purpose underlying the enactment of Section 117(f) of the 1939 Code was to accord to the retirement of obligations similar treatment as was then, and is now, accorded to their sale or exchange."

In view of the purpose of Section 117(f), it appears that before the passage of that section amounts received upon the sale of such evidences of indebtedness did qualify for capital gains treatment. If a sale before maturity of such obligations did not permit increments to be accorded capital gains treatment, it is unlikely that the Congress would have deliberately enacted a provision according them such favorable treatment upon retirement.

From the combination of this legislative history with the *Caulkins* decision it is possible to draw the following analogy: Section 117(f), under the *Caulkins* holding, provided that all amounts received in exchange for the retirement of a qualifying capital asset were capital gains. Because Section 117(f) was meant to be declaratory of the pre-existing law on sales before retirement, it follows that all amounts received on the pre-retirement sale of such debt obligations were likewise capital gains. The validity

of this analogy must be tested by a further inquiry into legislative, administrative and judicial history. However, before proceeding with that history it is necessary to examine the Government's position as to what the *Caulkins* case really held.

The Government contends that *Caulkins* was based solely upon an interpretation of Section 117(f). It says that the crucial fact in *Caulkins* was not that the debt obligations were discount obligations but that a retirement rather than a sale was involved. It has thus attempted to convince the Court that the *Caulkins* decision does not control this case, because in the present instance the notes were sold before maturity, rather than retired. It is true that the opinion in the *Caulkins* case primarily discusses the retirement factor; however, the Court is not convinced that increments on debt obligations which qualify under Section 117(f) would be accorded capital gains treatment if the obligations were retired, but would be taxed at regular income rates if they were sold before maturity. Even the Tax Court, which adopted that position in *Paine* v. *Commissioner,* 23 T. C. 391 (1954), Rev. 236 F. 2d 398 (8th Cir., 1956), and *Stanton* v. *Commissioner,* 34 T. C. 1 (1960), has now abandoned such a distinction. *Gibbons* v. *Commissioner,* 37 T. C. No. 57. The purpose of Section 117(f) surely was not to accord a more favorable tax treatment to income realized upon retirement of debt obligations than it would receive if they were sold before maturity. The quotation from *Mertens, supra,* also clearly indicates that such was not the case. Therefore, this Court is constrained to hold that the crucial fact in the *Caulkins* case was that the evidences of indebtedness were discount obligations.

The combination of the *Caulkins* case with Section 117 (f) thus indicates that appreciation realized on evidences of indebtedness, issued at an original discount and sold

before maturity, constituted a capital gain and not regular income. The remaining question, therefore, is whether the legislative, administrative and judicial treatments of discount obligations support this indication.

The earliest administrative decision upon this matter which has been furnished to the Court is Office Decision 1024 published in Vol. 2, Cum. Bul. 189 (1920), holding that original issue discount on bonds was not interest and, therefore, was not subject to special withholding provisions when the bonds were in the hands of foreign corporations. It is true, as the Government contends, that this opinion was not concerned with whether an appreciation resulting from such discount was a capital gain or regular income. It was concerned, however, with whether such gain was in fact interest. The opinion carefully examined the various factors involved and came to the conclusion that original issue discount, while in some ways like interest, differed from interest in other respects and was in fact not interest.

The writers appear to have been agreed that in the period following 1920 a taxpayer could not accrue bond discount, but had to report all of it in the year in which it was received. No part of the discount was allowed to be treated as income prorated over the life of the bond. See Accountant's Handbook, 2d Ed., p. 339 (1932); Newlowe, Intermediate Accounting, p. 205 (1939); and 4 Mertens Law of Federal Income Taxation, Section 23.162, p. 298. However, this well established rule does not meet the real issue in question, which is whether the income, in the year in which it was reported, was treated as a capital gain or as regular income. There is, however, one case from this period which again reiterates the fact that discount is not interest. That case is *Corn Exchange Bank* v. *Commissioner*, U. S. Board of Tax Appeals, 6 B. T. A. 158 (1927). Taxpayer had sought to amortize bond discount and premium. The Board of Tax Appeals

refused to allow such amortization. In doing so, it said, at page 161:

> "The discount on the bond purchased below par is unlike interest, which is a fixed charge and accrues periodically. The right to receive this discount, or difference between the cost of the bond and its par, cannot be determined in advance as the bond may be sold for more or less than its cost, or, perhaps, as in the case of many bonds, it may be redeemed prior to its maturity at an amount different from its principal or face amount of the bond. This discount is not earned or accrued in annual installments and cannot be income to the holder of the bond, either as additional interest or as a separate item of income."

The Government contends that the *Corn Exchange Bank* opinion was dealing only with regular discount as distinguished from original issue discount. It fully agrees that discount which is the result of such factors as an obligor's default in interest payments does not give rise to ordinary income. However, an examination of both the facts and the opinion in the *Corn Exchange Bank* case fails to reveal that the Court there was discussing any particular kind of discount. A practical examination of the transactions involved leads the Court to conclude that it is extremely likely that both kinds of discount were involved.

This case indicates that during the 1920's the Department of Internal Revenue, which prevailed in the *Corn Exchange Bank* decision, had contended that discount was not interest. And if discount was not interest, income resulting from discount could not have been taxable at regular rates on the premise that it was interest.

In 1940 the Internal Revenue Service held that income realized from the redemption of state discount bonds was

interest, and, accordingly, was non-taxable. G.C.M. 21890, 1940-1, Cum. Bul. 85. It said the courts had considered the nature of discount and found it to be like deferred interest. Such discount was, in effect, payment for the use of the money lent. The value of this ruling is questionable, however, because it necessarily involved statutory and constitutional limitations upon the federal taxation of state bonds. And while the ruling held that such discount was like interest, it carefully avoided holding that it was interest. Thus, at least until 1940, and possibly thereafter, the Internal Revenue Service held that discount was not interest. The legislative treatment of bond discount should be viewed against this administrative background.

In 1929 the Congress authorized the Treasury Department to issue non-interest-bearing discount obligations. The bill authorizing these notes, as passed by the House and as approved by the Senate Finance Committee, contained a provision that, as to profits attributable to the discount, "any gain from the sale or other disposition thereof shall be exempt from all taxation." Congressional Record, Senate, June 4, 1929, p. 2319. This provision for tax exemption met with considerable opposition upon the floor of the Senate, *because the Senators believed such profits were capital gains*, and feared that such a provision would open the way for the future exemption of all capital gains from taxation. Several members of the Senate engaged in a lengthy debate about the relationship between original issue discount and interest, and the tax consequences that flowed therefrom. That debate indicates that at least some members of the Senate believed that original issue discount was in fact a substitute for interest; but those who purported to be familiar with the subject pointed out that, under the then current practice of the Bureau of Internal Revenue, income attributable to original issue discount was treated as a capital gain and not as regular income. See page 2331, Congressional Record, *supra*.

The question was finally resolved by the insertion of a provision in the bill that amounts received as the result of original issue discount on these notes would be called interest, thus bringing them within the already existing interest exemption. Likewise, a similar provision was added as an amendment to the Second Liberty Bond Act of 1917, Title 31 U.S.C.A. § 757c(d). Thus, the legislative history indicates that appreciation resulting from this discount was statutorily transformed into interest to avoid its taxation as a capital gain.

These facts further substantiate the taxpayer's contention that during the period of the 1920's and early 1930's original issue discount was not considered interest, but rather gave rise to a capital gain. Furthermore, the Congress was aware of this construction and acquiesced therein by failing to statutorily change the rule until 1954. See Section 1232(a) (2) (A), Internal Revenue Code of 1954. This section now provides that, upon the sale or exchange of evidences of indebtedness issued by a corporation or a government, amounts of appreciation attributable to original issue discount will not be considered as gains resulting from the sale or exchange of a capital asset. In other words, in 1954, and governing evidences of indebtedness issued after the ones which are now before this Court, the Congress stated that appreciation resulting from original issue discount would henceforth be considered as regular income and not as capital gain.

The House report accompanying this section stated that under existing law such gains were taxed as capital gains if the bond was held to retirement, and that this section was enacted to change that rule insofar as appreciation resulting from original issue discount was concerned. 3 U. S. Code Congressional and Administrative News, 1954, p. 4110. The report of the Senate Finance Committee is less helpful. It merely stated that "There is some uncertainty as to the status of proceeds in these transactions,

i. e., as capital gain or as interest income where the bond or other evidence of indebtedness has been issued at a discount * * *." 3 U. S. Code Congressional and Administrative News, 1954, p. 4745. In support of its statement that there was some confusion as to the current status of the law, the Senate report compared *Commissioner* v. *Caulkins* to I. T. 3486, 1941-2 Cum. Bul., p. 76. However, the Internal Revenue holding, upon which the Senate Committee relied, dealt only with a specific statutory provision which provided that such gains realized on the sale of Treasury bills should be interest. That provision had been enacted to make such gains non-taxable by bringing them within the exemption which interest enjoyed. Thus, the Senate Report does not cite any evidence of uncertainty insofar as the generally applicable principles are concerned.

At various times the Congress has enacted special provisions regarding the treatment of discount. For instance, the Internal Revenue Code of 1939, Sections 201(e) and 207(e), provided that stock and mutual life insurance companies must accrue discount.

And in 1938 the House Ways and Means Committee discussed the relationship between discount and interest. That Committee report stated:

> "It is important also to emphasize that there is no clear separation, in practice, between capital gains and ordinary income; * * * *A bond purchased at a premium results in a capital loss when redeemed at par, and a bond purchased at a discount, in a capital gain.*" Hearings on H. R. 9682, Subcommittee of Committee on Ways and Means, 75th Congress, Third Session, p. 38. (Emphasis added.)

Here again is evidence of Congressional knowledge that appreciation due to bond discount was a capital gain. The Sub-

committee recommended that no change be made in this rule.

And again, in Section 42(b) of the 1939 Internal Revenue Code, the Congress gave taxpayers an election to treat as current income the periodic increases in redemption value of non-interest-bearing obligations issued at a discount when such obligations were redeemable for fixed amounts which increased at stated intervals.

Thus the evidence indicates that the Congress clearly believed that appreciation resulting from original issue discount was a capital gain. With this knowledge Congress adopted various pieces of specific legislation providing for special treatment of discount in certain specified situations. However, Congress took no action to change the general law. These facts indicate a Congressional intention, until 1954, that capital gains treatment continue to be accorded to gains resulting from bond discount. And there was no indication of any thought that different treatment should be given to gains resulting from original issue discount than was accorded those resulting from other types of discount.

Both parties have cited various explanations and public policies underlying the special treatment which the Congress has accorded to capital gains. As the Government has indicated, there are several reasons for this special treatment. However, even the Government cannot deny that one important reason is to avoid taxing, at unusually high rates, income which has in fact been earned over a number of years but which is realized only in the year of sale. In other words, the accumulation of income actually accrued over a period of years, but realized only in the year of sale, which is inherent in the profitable sale of most capital assets, would, under our system of highly progressive income taxation, result in a taxation of such income at far higher rates than would have been the case if the income had been reportable in each of the years in which it accrued but was not realized. The capital gains

provisions place a limit upon the extent to which such gains can be taxed. In view of this purpose, it certainly appears that the long-term appreciation, resulting from original issue discount of bonds and other evidences of indebtedness, can be appropriately fitted within that category of appreciation which is accorded the special capital gains treatment.

In several instances the Tax Court has had occasion to consider the proper method of taxing gains resulting from original issue discount. It must be remembered that in the Corn Exchange Bank case, supra, the Board of Tax Appeals held that discount was not interest. The next occasion on which the Court was faced with the problem was in Caulkins v. Commissioner, 1 T. C. 656 (1943), where it decided that original issue discount gave rise to a capital gain and not to regular income. It was this opinion which was affirmed by the Sixth Circuit in Commissioner v. Caulkins, supra.

In 1954, on a complex factual situation, it held that discount was really interest and therefore gave rise to regular income when the securities were sold before maturity. Paine v. Commissioner, 23 T. C. 391 (1954). That holding was reversed by the Eighth Circuit in Paine v. Commissioner, 236 F. 2d 398 (1956). While it cannot be said that the Eighth Circuit held that discount resulted in a capital gain, that Court did hold that the appreciation involved in the Paine case was not interest. The language of the Court further indicates, however, that it did not think that discount created gains which were taxable as regular income.

Another case before the Court was Commissioner v. Morgan, 30 T. C. 881 (1958), involving accumulative investment certificates identical to those in the Caulkins case. The Tax Court held that the appreciation on these certificates was a capital gain. The Commissioner appealed that determination to the Ninth Circuit, which reversed the Tax Court. Commissioner v. Morgan, 272 F. 2d 936 (1959).

The Court of Appeals considered the Sixth Circuit's Caulkins decision and refused to follow it. The Court held that Section 117(f) was designed only to allow capital gains treatment to be accorded to "true" capital gains. The Court refused to give the language of Section 117(f) the all-encompassing scope that it had been accorded by the Sixth Circuit.

The Tax Court reaffirmed its holding that such gains were capital gains in Goodstein v. Commissioner, 30 T. C. 1178 (1958). And it was again faced with another of the Caulkins-type accumulative investment certificates in Kormendy v. Commissioner, 18 T. C. M. 353 (1959). This case was decided after Morgan but before the reversal of Morgan by the Ninth Circuit. Again, the Tax Court affirmed its Morgan and Caulkins holdings.

Finally, in 1960, after the reversal of the Morgan decision by the Court of Appeals, the Tax Court again had a similar problem in Stanton v. Commissioner, 34 T. C. 1 (1960). In that case the taxpayer had purchased short-term Government notes and commercial paper at a discount. This paper he sold before maturity but after holding for more than six months. The excess of the amount realized over the cost was reported as a long-term capital gain. The Tax Court held that the appreciation was regular income because the notes were sold before maturity. In support of this decision the Court cited its Paine opinion, which it said had been reversed on other grounds.

The most recent case that it has considered was Gibbons v. Commissioner, 37 T. C. No. 57. In Gibbons the Tax Court held that discount was *always* interest, and thus regular income, no matter whether it was realized upon a sale or exchange before retirement, or upon the retirement of a debt obligation. Thus, in Gibbons, the Tax Court completely rejected the Caulkins decision, and abandoned the distinction that it had made in Paine and Stanton between gains realized on a sale and gains realized on a retirement.

Appendix B—Conflicting Opinions

The problem of original issue discount has been considered recently by a number of constitutional courts. Most of the decisions which were cited to this Court have but again reaffirmed the validity of the general principle for which the Government contends. When the evidences of indebtedness in question were interest-bearing obligations the applicability of this proposition cannot be questioned. Cases which have dealt with the rule in such situations are: Fisher v. Commissioner, 209 F. 2d 513 (6th Cir., 1954), cert. den. 347 U. S. 1014, 74 S. Ct. 868, 98 L. Ed. 1136; United States v. Langston, 308 F. 2d 729 (5th Cir., 1962); Arnfeld v. United States, 163 F. Supp. 865, 143 Ct. Cl. 277 (1958), cert. den. 359 U. S. 943, 79 S. Ct. 722, 3 L. Ed. 2d 676; and Jaglom v. Commissioner, 303 F. 2d 847 (2nd Cir., 1962); cf. Commissioner v. Phillips, 275 F. 2d 33 (4th Cir., 1960). Thus, there are only five cases which actually have dealt with the treatment to be accorded to gains resulting from original issue discount. Those cases are: Commissioner v. Caulkins, 144 F. 2d 482 (6th Cir., 1944); Commissioner v. Morgan, 272 F. 2d 936 (9th Cir., 1959); Rosen v. United States, 288 F. 2d 658 (3rd Cir., 1961); United States v. Harrison, 304 F. 2d 835 (5th Cir., 1962); and Pattiz v. United States, Ct. Cl., 311 F. 2d 947 (1963). The Morgan and Rosen decisions were based upon the same fact situation that was presented to the Sixth Circuit in Caulkins. The results in the Third and Ninth Circuits were obtained by a specific rejection of the Caulkins decision. In neither case did the Court examine the legislative, administrative or judicial history which has surrounded the treatment of original issue discount. Instead, the Court was presented with the proposition on an almost *de novo* basis and, perhaps naturally enough in the absence of familiarity with the detailed history, fell back upon the broad, general proposition for which the Government here contends. Likewise, the Harrison and Pattiz decisions were based upon a specific rejection of Caulkins and on an adoption of the Morgan

and Rosen opinions, and neither case considered the historical treatment of original issue discount. Therefore, while it is true that the recent cases have adopted the Government's position, they have done so (1) without a discussion of the historical treatment of gains resulting from original issue discount, and (2) only upon a rejection of the Caulkins case, which is controlling in this Circuit.

The following factors support the taxpayer's contention: (1) the opinions of the Department of Internal Revenue and the Board of Tax Appeals, during the 1920's and early 1930's that discount was not interest; (2) Congressional belief, expressed both in 1929 upon authorization of Treasury bills and later in the Second Liberty Bond Act, that original issue discount resulted in a capital gain, and consequent Congressional action to avoid that result; (3) the report of the Subcommittee of the Ways and Means Committee of the House of Representatives, in 1938, that discount gave rise to a capital gain; (4) Congressional enactment of various specific pieces of legislation providing that appreciation resulting from discount would be treated as other than a capital gain; (5) the failure of the Congress to take any action to change the treatment of bond discount except in regard to highly specialized factual situations; (6) the passage of Section 117(f), as interpreted by the Caulkins decision, indicating that all amounts received upon retirement, and attributable to original issue discount, were capital gains; (7) the numerous early opinions of the Tax Court that original issue discount resulted in a capital gain; and (8) the fact that none of the cases which have rejected Caulkins have considered the historical treatment of bond discount. Against these factors, and in support of the Government's contention, it is possible to infer, from several administrative rulings dealing with specific statutory situations, that bond discount was really interest and was taxable as regular income. The 1929 Senate debate and the 1938 House hearings refute any possible implication from

other Congressional enactments that original issue discount resulted in regular income. The factors supporting the taxpayer's contention are clearly of controlling weight.

It may well be that, in financial circles at least, original issue discount is considered to be a form of interest. If this is the case, it is certainly understandable why the various courts of appeal, which have considered this question on an almost *de novo* basis, have held that original issue discount resulted in regular income to the taxpayer. It is likewise true that there has been a trend—commencing with certain legislative enactments, proceeding through some administrative interpretations, and culminating with the Congressional enactment of 1954—toward classifying appreciation resulting from original issue discount as interest. This trend began with certain very specific factual situations and expanded to include nearly all governmental and corporate evidences of indebtedness. However, careful study of this developing trend confirms the Court's belief that it has effectuated a change in the law. The facts in this case are not within any of the specific factual situations for which this change has been made and, therefore, the Court is constrained to hold that, as to the notes here in question, the appreciation for taxation purposes was not interest but, rather, an appreciation on capital, and was therefore taxable as a capital gain.

Should it be required, this memorandum will be adopted as findings of fact and conclusions of law under Section 52(a), Federal Rules of Civil Procedure.

INDEX

CITATIONS

In the Supreme Court of the United States

OCTOBER TERM, 1964

No. 486

W. PALMER DIXON, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the district court (Pet. 8a–21a) is reported at 224 F. Supp. 358. The opinion of the court of appeals (Pet. 1a–7a) is not yet officially reported.

JURISDICTION

The judgment of the court of appeals was entered on June 19, 1964. (Pet. 2.) The petition for a writ of certiorari was filed on September 11, 1964. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether the excess of the face amount of a note over the amount of money for which it was issued represents interest which an accrual-basis lender must

accrue during the period that the note is held. Alternatively, the question is whether, if the "interest" is not currently accruable, the portion of the proceeds of the lender's subsequent sale of the note which is attributable to the excess is taxable as ordinary income or as capital gain.[1]

2. Whether the Commissioner was estopped to challenge the taxpayers' treatment of their gain from the sale of notes issued at a discount as capital gain because he had previously announced, and only later withdrew, his acquiescence in a prior decision involving a similar but distinguishable question.

STATUTES AND REGULATIONS INVOLVED

The relevant statutes and regulations are set out in the Appendix, pp. 13–15, *infra*.

STATEMENT

Petitioners are partners in the investment firm of Carl M. Loeb, Rhoades & Company. At various times during the taxable year 1952, the partnership purchased 33 short-term, non-interest bearing notes, either directly from the obligor corporation, or through

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[1] Petitioners phrase the question as one of the treatment of the proceeds from the sale of the notes (Pet. 2). Technically, however, the deficiencies determined and upheld in this case were based upon the current accruability of the "interest" regardless of whether there was a sale in the taxable year. We have framed the question in an alternative form only to encompass the manner in which petitioners state it. In fact, we do not believe there is any dispute that, if the excess of the note over the issuing price is properly to be treated as "interest," the proper method of accounting for it in this case was by accrual, rather than by waiting to account for the proceeds of a sale or redemption of the note.

agents or dealers. The notes bore maturity dates ranging from 190 to 272 days from the date of issue, and all were issued at discounts varying between 2⅜% and 3¾% of the face value. Of these notes, 20 were sold during 1952 prior to maturity after being held for periods of six months or longer and 13 remained on hand unmatured (Pet. 3a, 8a).

In its information return for 1952, the partnership did not accrue interest on any of the notes and reported the gain from the sale of the 20 notes during that year as long-term capital gain. In reporting their distributive shares of the partnership income on their individual returns, petitioners treated the notes in the same manner. The Commissioner determined that the excess of the face amount of the notes over the amount of money for which they were issued represented interest accruing over the term of the notes. Since the partnership was on the accrual basis, the interest accruing on all 33 of the notes during the period they were held by the partnership was determined to be includible in partnership income and hence in petitioners' distributive shares.[2] Petitioners paid the resulting deficiencies ($369,329) and in due course brought this suit for refund (Pet. 3a, 8a–9a). Both the district court (Pet. 8a–21a) and the court of appeals (Pet. 1a–7a) upheld the Commissioner's determination and denied the refunds.

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[2] As the court of appeals noted, "no question has been raised as to the propriety of taxing the individual partners for notes held by the partnership, and the taxpayers have conceded that if the discount *did* represent ordinary income, that income was realized upon each of the thirty-three notes held, and was not dependent upon a sale" (Pet. 4a).

ARGUMENT

In holding that original-issue discount must be accounted for as "interest," the decision below, although clearly right and supported by the great weight of authority, is in direct conflict with the decisions of the Sixth Circuit. Accordingly, we acquiesce in the granting of certiorari to resolve that question. On the second question presented (estoppel of the Commissioner by his prior acquiescence in another case), the decision is not only correct but there is no conflict of decisions or any other reason for review by this Court. Certiorari, if granted, should therefore be limited to the first question presented.

I

1. In its treatment of original-issue discount, the decision below is correct. There is no dispute that the result would be proper if the notes had in terms provided for interest.[3] The only question is whether there is a difference for tax purposes between these two transactions: (1) *A* gives *B* \$100 for *B*'s promise to pay \$100 plus 6% interest (*i.e.*, \$106) a year hence; and (2) *A* gives *B* \$100 for *B*'s promise to pay \$106 a year hence. The only discernible difference between the transactions is that in the first the additional \$6 to be paid is labeled "interest", while in the second the additional \$6 to be paid is not given a name.

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[3] As to accruability of the "interest," see note 2, *supra*. As to the treatment of accrued "interest" on the sale or redemption of a note, see *Jaglom* v. *Commissioner*, 303 F. 2d 847 (C.A. 2); *Fisher* v. *Commissioner*, 209 F. 2d 513 (C.A. 6), certiorari denied, 347 U.S. 1014; *United States* v. *Langston*, 308 F. 2d 729 (C.A. 5); *First Kentucky Co.* v. *Gray*, 309 F. 2d 845 (C.A. 6).

That difference, in turn, is wholly immaterial, for, as this Court has repeatedly emphasized, tax consequences turn upon the economic substance of transactions, not the labels used by the parties. *E.g.*, *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260, 266–267. Interest is merely "compensation for the use or forebearance of money" (*Deputy* v. *DuPont*, 308 U.S. 488, 498); and in both transactions the additional $6 to be paid is neither more nor less than that.

That "original-issue discount" is but another name for interest is equally established by authority. First, by the decision of this Court holding that the issuer may deduct the excess of the redemption price over the issuing price as interest. *Helvering* v. *Union Pacific Co.*, 293 U.S. 282. Second, by the decisions of the First, Second, Third, Fifth and Ninth Circuits, the Court of Claims, and the Tax Court holding that the holder of the note realizes ordinary interest income upon the sale or redemption of the note to the extent that the proceeds are attributable to the original-issue discount.[4]

2. As petitioners state, however, the decision below (like those of the other courts noted above) is in acknowledged conflict with the decisions of the Sixth

[4] *Real Estate Investment Trust of America* v. *Commissioner*, 334 F. 2d 986 (C.A. 1); *Rosen* v. *United States*, 288 F. 2d 658 (C.A. 3); *United States* v. *Harrison*, 304 F. 2d 835 (C.A. 5), certiorari denied, 372 U.S. 934; *Commissioner* v. *Morgan*, 272 F. 2d 936 (C.A. 9); *Pattiz* v. *United States*, 311 F. 2d 947 (Ct. Cls.); *Schwartz* v. *Commissioner*, 40 T.C. 191; *Leavin* v. *Commissioner*, 37 T.C. 766. The *Morgan* case involved an accrual-basis taxpayer and there, as here, the court held that the taxpayer must report the original-issue discount ratably as it accrued.

Circuit holding the entire gain to be taxable only as capital gain upon either a sale or a redemption of a note issued at a discount. *Midland-Ross Corp.* v. *United States,* 214 F. Supp. 631, affirmed *per curiam,* 335 F. 2d 561 (printed at Pet. 23a–42a) (sale); *Commissioner* v. *Caulkins,* 144 F. 2d 482 (redemption). To be sure, the taxable event in this case was treated as being, not the "sale" of notes, but the "accrual" of the interest during the partnership's holding of the notes, and that circumstance helps to emphasize the ultimate irrelevance to the question of the "sale or exchange" provisions upon which the Sixth Circuit has relied. In principle, however, if "interest" in the form of original-issue discount must be accrued by an accrual-basis taxpayer, it equally follows that a cash-basis taxpayer must report as ordinary income, when paid, the portion of the proceeds of a sale of a note attributable to such accrued "interest," just as he is admittedly required to do upon a sale of a note with accrued interest labeled as such. Nor was the difference in the method of accounting decisive to the court below, for it is plain from its opinion that, if the partnership had been on the cash basis, the court would equally have held that its gain from the sale of the 20 notes was taxable as ordinary income.

Even though it does not justify the difference in results, the difference between accruability of the interest and the treatment of the proceeds from a sale might afford a sufficient distinction to make review by this Court unnecessary if it served to distinguish

all of the cases. With the sole exception of the *Morgan* case, however, the decisions of the other Circuits cited above (note 4) arose in the same context as the Sixth Circuit cases (treatment of a sale or redemption), and there is thus a square conflict even apart from the decision below. Accordingly, we do not believe that the difference in the method of accounting affords a sufficient basis on which to oppose the petition in this case. Indeed, if the basic question is to be considered at all by this Court—as seems unavoidable—it seems highly desirable that it be presented in the context of accrual accounting as well as in the context of the treatment of sale proceeds.

We are simultaneously filing a petition for certiorari in the *Midland-Ross* case decided by the Sixth Circuit, in acknowledged conflict with the decision below, on July 29, 1964, *supra*. That case involves notes that were substantially identical to those in this case, even to the extent of being issued by the same financial institutions. The only difference is that the deficiencies in that case were premised upon treating the gain from the *sale* of the notes as ordinary income rather than upon requiring the "interest" to be accrued.[5] Both cases involve stipulated facts and very simple records, and in order to have the question presented in both contexts (accruability and treatment of sale proceeds), we suggest that the Court

[5] The taxpayer in the *Midland-Ross* case was in fact on the accrual basis. The only reason the deficiencies were based on the gain from the sale of the notes (rather than on accrual principles) was that all of the notes were sold in the same year in which they were acquired, making the results the same (but for negligible amounts).

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grant both petitions and set the two cases for argument together.

We are also advised that the taxpayer will file a petition for certiorari in the *Real Estate Investment Trust* case decided by the First Circuit, in conformity with the decision below and in conflict with the Sixth Circuit, on July 28, 1964, *supra.* We shall defer until our receipt of that petition any comment on whether it should also be granted or should merely be held to await the disposition of this case and the *Midland-Ross* case.

3. This case, like the others mentioned above, arises under the 1939 Code. Section 1232 of the 1954 Code expressly provides for ordinary-income treatment of the portion of the gain from the sale or redemption of notes that is attributable to original-issue discount. The question presented in this case, however, remains of continuing importance because of three significant limitations upon the scope of § 1232.

First, § 1232 applies only to obligations *issued* after December 31, 1954, so that the prior law would control any sale or redemption, even after 1954, of such obligations issued prior to 1955. While ten years have now elapsed since that date, we have no solid basis on which to dispute petitioners' claim that not only have numerous such transactions occurred in years which are still open but there may be some such obligations still outstanding (Pet. 5). And while the pending cases of which we are aware are relatively few in number,[6] they involve not insignificant sums

[6] In addition to the three cases now or about to be pending in this Court on petitions for certiorari (this case from the Second Circuit, *Midland-Ross* from the Sixth Circuit, and

of money (this case, for example, involves $369,329, plus interest).

Second, § 1232 applies only to obligations issued by a corporation or a governmental body, and not to obligations issued by individuals. While all of the litigated cases seem to have involved corporate obligations, the same question would be presented by notes issued by individuals.

Third, § 1232 does not itself answer the question whether an accrual-basis taxpayer must accrue "interest" in the form of original-issue discount in the same manner that stated interest must be accrued. Section 1232 was in effect a legislative overruling, at least for the future, of the Sixth Circuit's earlier decision in the *Caulkins* case, and, as often happens in such cases, it deals in terms not with the underlying principle but only with the particular manifestation, leaving the courts still to grapple with the "related" problems that might arise. Thus, § 1232 does not in terms say that the excess of the face amount of a note over the amount of money for which it was issued *is* interest and is to be accounted for in all respects in the same manner in which stated interest is accounted for. It is rather limited to the specific question involved in the *Caulkins* case and provides

Real Estate Investment Trust from the First Circuit), and the cases of the other partners of petitioners which are pending in the Second Circuit and will, by stipulation, be controlled by the outcome of this case (*Koyle* v. *United States*, No. 28,862; *Hornstein* v. *United States*, No. 28,863; and *Erpf* v. *United States*, No. 28,895), we are aware of only the following three cases now pending: *Kehaya* v. *United States*, Ct. Cls. No. 27-61; *May* v. *Commissioner*, T.C. Docket No. 67,659; and *Meyer* v. *Commissioner*, T.C. Docket No. 1198-63.

simply that the "gain" on a "sale" (or a redemption treated as a sale) of a note, to the extent that it does not exceed the original-issue discount pro-rated over the period of holding, "shall be considered as gain from the sale or exchange of property which is not a capital asset" (*i.e.*, as ordinary income). Other questions which turn upon the characterization of original-issue discount as "interest" are thus not expressly answered by the statute (although its underlying purpose may, of course, provide a guide for their solution). And chief among those questions is the question directly in issue in this case—to wit, whether an accrual-basis taxpayer must accrue interest in the form of original-issue discount as well as interest which is labeled as such.

While § 1232 does significantly lessen the importance of the question for the future, the result of those limitations on its scope is that the question remains of at least as much continuing importance as many questions on which this Court is called upon to resolve a conflict. The subsequent statutory developments, therefore, do not provide a sufficient basis to oppose the petition in the face of the recently-affirmed conflict of decisions. We accordingly join with petitioners in urging that the Court grant certiorari on that question.

II

The second question presented by the petition is whether the Commissioner is estopped to challenge petitioners' treatment because he initially acquiesced in the decision in *Commissioner* v. *Caulkins, supra,*[7]

[7] Rev. Rul. 11907, 1944 Cum. Bull. 5.

and did not withdraw the acquiescence until after the transactions involved in this case.[8] That question is insubstantial for two reasons: first, because, as shown in detail in the district court's opinion (Pet. 13a–18a), the *Caulkins* case was distinguishable on its facts and any reliance by petitioner upon the acquiescence in it was misplaced; and second, because in any event "the doctrine of equitable estoppel is not a bar to the correction by the Commissioner of a mistake of law" (*Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, 183; see also, *e.g.*, *Manhattan Co.* v. *Commissioner*, 297 U.S. 129; § 7805 of the 1954 Code, *infra*, p. 19). Nor is there a conflict of decisions or any other reason for review of that question by this Court.

CONCLUSION

For the reasons stated, the petition for certiorari should be granted, but the grant should be limited to Question 1 as stated in the petition.

Respectfully submitted.

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OCTOBER 1964.

[8] See Rev. Rul. 56–299, 1956–1 Cum. Bull. 603, superseding Rev. Rul. 55–136, 1955–1 Cum. Bull. 213.

APPENDIX

A. INTERNAL REVENUE CODE OF 1939 AND REGULATIONS 118.

Internal Revenue Code of 1939 (26 U.S.C., 1952 ed.):

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived * * * from interest, * * * or gains or profits and income derived from any source whatever. * * *

* * * * *

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period * * * in accordance with the method of accounting regularly employed in keeping the books of such taxpayers; * * *.

SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

(b) *Noninterest-bearing obligations issued at discount.*—If, in the case of a taxpayer owning any noninterest-bearing obligation issued at a discount and redeemable for fixed amounts increasing at stated intervals or owning an obligation described in paragraph (2) of subsection (d), the increase in the redemption price of such obligation occurring in the taxable year does not (under the method of accounting used in computing his net income) constitute income

to him in such year, such taxpayer may, at his election made in his return for any taxable year beginning after December 31, 1940, treat such increase as income received in such taxable year. * * *

(c) *Short-term obligations issued on discount basis.*—In the case of any obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, the amount of discount at which such obligation is originally sold shall not be considered to accrue until the date on which such obligation is paid at maturity, sold, or otherwise disposed of.

(d) *Matured United States Savings Bonds.*—In the case of a taxpayer who—

(1) holds a series E United States savings bond at the date of maturity, and

(2) pursuant to regulations prescribed under the Second Liberty Bond Act retains his investment in the maturity value of such series E bond in an obligation, other than a current income obligation, which matures not more than ten years from the date of maturity of such series E bond,

the increase in redemption value (to the extent not previously includible in gross income) in excess of the amount paid for such series E bond shall be includible in gross income in the taxable year in which the obligation is finally redeemed or in the taxable year of final maturity, whichever is earlier. The provisions of this subsection shall not apply to a corporation, and shall not apply in the case of any taxable year for which the taxpayer's net income is computed upon the basis of the accrual method of accounting or

for which an election made by the taxpayer under subsection (b) is applicable.

* * * * *

SEC. 48. DEFINITIONS.

* * * * *

(c) *"Paid or incurred," "paid or accrued."*—The terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under this Part.

* * * * *

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

(1) *Capital assets.*—The term "capital assets" means property held by the taxpayer * * * but does not include—

* * * * *

(D) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

* * * * *

(4) *Long-term capital gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, * * *.

* * * * *

U.S. Treasury Regulations 118 (1939 Code):

§ 39.22(a)–17 *Sale and purchase by corporation of its bonds.* * * * (c) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. * * *

* * * * *

§ 39.42–7 *Short-term obligations issued on discount basis.* In the case of any obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, the amount of discount at which such obligation is originally sold shall not be considered to accrue until the date on which such obligation is paid at maturity, sold, or otherwise disposed of. Accordingly, if a taxpayer who computes his net income on the accrual basis purchases upon issuance a United States Treasury bill and holds it until maturity, the entire amount of the discount at which the bill was originally sold accrues on the date of maturity; and if such a taxpayer holds a United States Treasury bill for a period less than its life, the portion of the original discount attributable to such period accrues only on the date on which he sells or otherwise disposes of the bill or receives payment at maturity. The original discount or the portion of such discount, as the case may be, is includible only in the gross income for the taxable year in which the taxpayer sells or otherwise disposes of the bill or receives payment at maturity. For examples illustrating rules for computation of income from sale or other disposition of obligations of the type described in this section, see § 39.117(a)–1.

*   *   *   *   *

§ 39.117(a)–1 *Meaning of terms.*

*   *   *   *   *

(d) Obligations of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable

without interest at a fixed maturity date not exceeding one year from the date of issue, are excluded from the term "capital assets." * * * It is, therefore, not necessary for a taxyaper, other than a life insurance company subject to taxation only on interest, dividends, and rents, to segregate the original discount accrued (see § 39.42-7) and the gain or loss realized upon the sale or other disposition of any such obligation.

Example (1). A (not a life insurance company) buys a $100,000 90-day Treasury bill upon issuance for $99,998. As of the close of the forty-fifth day of the life of such bill, he sells it to B (not a life insurance company) for $99,999.50. The entire net gain to A of $1.50 may be taken into account as a single item of income, without allocating $1 to interest and $0.50 to gain. If B holds the bill until maturity his net gain of $0.50 may similarly be taken ito account as a single item of income, without allocating $1 to interest and $0.50 to loss.

Example (2). The facts in this example are the same as in example (1) except that the selling price to B is $99,998.50. The net gain to A of $0.50 may be taken into account without allocating $1 to interest and $0.50 to loss, and, similarly, if B holds the bill until maturity his entire net gain of $1.50 may be taken into account as a single item of income without allocating $1 to interest and $0.50 to gain.

* * * * *

B. INTERNAL REVENUE CODE OF 1954.

Internal Revenue Code of 1954 (26 U.S.C., 1958 ed.):

Sec. 1232. BONDS AND OTHER EVIDENCES OF INDEBTEDNESS.

(a) *General Rule.*—For purposes of this subtitle, in the case of bonds, debentures, notes or certificates or other evidences of indebtedness,

which are capital assets in the hands of the taxpayer, and which are issued by any corporation, or government or political subdivision thereof—

* * * * *

(2) *Sale or exchange.*—

(A) [As amended by Sec. 50(a), Technical Amendments Act of 1958, P.L. 85–866, 72 Stat. 1606] *General rule.*—Except as provided in subparagraph (B), upon sale or exchange of bonds or other evidences of indebtedness issued after December 31, 1954, held by the taxpayer more than 6 months, any gain realized which does not exceed—

* * * * *

(ii) * * * an amount which bears the same ratio to the original issue discount (as defined in subsection (b)) as the number of complete months that the bond or other evidence of indebtedness was held by the taxpayer bears to the number of complete months from the date of original issue to the date of maturity,

shall be considered as gain from the sale or exchange of property which is not a capital asset. Gain in excess of such amount shall be considered gain from the sale or exchange of a capital asset held more than 6 months.

* * * * *

(b) *Definitions.*—

(1) *Original issue discount.*—For purposes of subsection (a), the term "original issue discount" means the difference between the issue price and the stated redemption price at maturity. * * *

* * * * *

SEC. 7805. RULES AND REGULATIONS.

* * * * *

(b) *Retroactivity of Regulations or Rulings.*—The Secretary or his delegate may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect.

* * * * *

U.S. GOVERNMENT PRINTING OFFICE: 1964

IN THE

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October Term, 1964

No. 486

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Petitioners,

against

THE UNITED STATES OF AMERICA,

Respondent.

REPLY BRIEF FOR PETITIONERS

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Petitioners,

against

THE UNITED STATES OF AMERICA,

Respondent.

REPLY BRIEF FOR PETITIONERS

I.

The Respondent in its brief expressly recognizes the direct conflict between the decision below and that of the Sixth Circuit in *Midland-Ross Corp.* v. *U. S.,* 214 F. Supp. 631, affirmed per curiam, 335 F. 2d 561 (C. A. 6th, 1964) and accordingly acquiesces in the granting of certiorari (Resp. 4). Yet, in portions of Respondent's brief (Resp. 6) there is the suggestion that the question before the Courts

below may be regarded as other than completely identical because in this case the Respondent accrued the original issue discount as ordinary income in the nature of interest and in *Midland-Ross Corp.* taxed the original issue discount as ordinary income in the nature of interest when realized on a sale. However, this cannot becloud the fact that the two cases are in direct conflict.

In *Midland-Ross Corp.* the taxpayer held securities identical to those here involved. The securities were sold prior to maturity. The original issue discount thus realized was reported by the taxpayer and upheld by the Sixth Circuit as capital gain. In this case, there likewise exists sales before maturity and a reporting by petitioners of the original issue discount thus realized as capital gain. This reporting was disallowed by the Courts below on the ground that original issue discount under the 1939 Code is when realized for tax purposes ordinary income in the nature of interest. The issue therefore is identical: Is original issue discount when realized ordinary income or capital gain under the 1939 Internal Revenue Code.

II.

The writ of certiorari should not be limited to Question I. The second issue raised as to the circumstances under which the Commissioner of Internal Revenue may retroactively apply a change of position despite reliance and detriment, is of very substantial importance in the administration of the federal tax laws.*

* An example of the importance of the question and of the extent to which the federal courts are seeking guidance may be found in the recent decision in *Brecklein* v. *Bookwater*, 231 F. Supp. 404 (W. D. Mo., 1964). See also *Schuster* v. *Commissioner*, 312 F. 2d 311 (C. A. 9th, 1962); *Lesavoy Foundation* v. *Commissioner*, 238 F. 2d 589 (C. A. 3rd, 1956).

The Government contends (Resp. 11) that it is unnecessary to pass upon the taxpayer's claim of reliance because (a) the *Caulkins* case is distinguishable on its facts and (b) the Commissioner may always retroactively correct a mistake of law without regard to taxpayers reliance on his prior position.

This position is without merit and should not be the basis for a foreclosure of any review of the claim of reliance. First, the court below, in contrast to the Government's present position, recognized that the securities at issue in *Caulkins* were analogous to those involved in the present case (Pet. 6a). Second, the court below misinterpreted the holding of the Supreme Court in *Automobile Club of Michigan* v. *Commissioner,* 353 U. S. 180 (1957).

This Court in the *Automobile Club of Michigan* case allowed the change of position to be applied to the taxpayer there involved because the change was first made effective for a year in which taxpayer had been put on notice of the change by a publicly-issued General Counsel's Memorandum, and secondly, because the change of position was being uniformly applied to all taxpayers similarly situated.

Neither of these factors is present here. In 1952, petitioners had no reason to believe that a change of position was even under consideration. And the change of position was not applied uniformly to all taxpayers. Rev. Rul. 55-136, 1955-1 Cum. Bull. 213, does not apply the change of position retroactively against taxpayers where the securities at issue are Accumulative Installment Certificates purchased from the Investors Syndicate. There is thus no dealing with all taxpayers "upon the same basis" as was the case in *Automobile Club of Michigan.* It was upon this circumstance that this Court emphatically rested its approval of retroactive application of change of position, 353 U. S. at p. 186.

The Commissioner apparently believes that it may retroactively change his position in any case in non-uniform and thus discriminatory manner, and without giving the slightest notice of forthcoming change. Unless this Court grants review of the issue, the Commissioner will continue so to believe and taxpayers will remain unsettled as to the significance and reliability of the Commissioner's announced positions and therefore will continue to litigate such actions of the Commissioner.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the petition for a writ of certiorari be granted as to all questions.

November 9, 1964.

Respectfully submitted,

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No. 486

W. Palmer Dixon, Joan Dixon, Everett W. Cady, Clarissa H. Cady, J. Herbert Higgins, Marion Blair Higgins, Stephen A. Koshland, Carol F. Koshland, Henry A. Loeb, John L. Loeb, Carl M. Loeb, Jr., and Margaret L. Kempner, as Executors of the Last Will and Testament of Carl M. Loeb, Sr., Deceased, Henry A. Loeb, John L. Loeb, Carl M. Loeb, Jr., and Alan H. Kempner, as Executors of the Last Will and Testament of Adeline M. Loeb, Deceased, John L. Loeb, Frances L. Loeb, Henry A. Loeb, Louise S. Loeb, Clifford W. Michel, Barbara R. Michel, Mark J. Millard, Claire Millard, Henry Parish, 2nd, Dorothy Parish, Hubert R. A. Simon, Samuel L. Stedman and Gerda C. Stedman,

Petitioners,

against

The United States of America,

Respondent.

BRIEF FOR PETITIONER ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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IN THE

Supreme Court of the United States

October Term, 1964

No. 486

W. PALMER DIXON, JOAN DIXON, EVERETT W. CADY, CLARISSA H. CADY, J. HERBERT HIGGINS, MARION BLAIR HIGGINS, STEPHEN A. KOSHLAND, CAROL F. KOSHLAND, HENRY A. LOEB, JOHN L. LOEB, CARL M. LOEB, JR., and MARGARET L. KEMPNER, as Executors of the Last Will and Testament of CARL M. LOEB, SR., Deceased, HENRY A. LOEB, JOHN L. LOEB, CARL M. LOEB, JR., and ALAN H. KEMPNER, as Executors of the Last Will and Testament of ADELINE M. LOEB, Deceased, JOHN L. LOEB, FRANCES L. LOEB, HENRY A. LOEB, LOUISE S. LOEB, CLIFFORD W. MICHEL, BARBARA R. MICHEL, MARK J. MILLARD, CLAIRE MILLARD, HENRY PARISH, 2ND, DOROTHY PARISH, HUBERT R. A. SIMON, SAMUEL L. STEDMAN and GERDA C. STEDMAN,

Petitioners,

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THE UNITED STATES OF AMERICA,

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BRIEF FOR PETITIONER ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Opinions Below

The opinion of the District Court is reported at 224 F. Supp. 358, and also appears at R. 4-15.* The opinion of the Court of Appeals is reported at 333 F. 2d 1016, and also appears at R. 44-49.

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* "R." references are to Transcript of Record.

Jurisdiction

The Judgment of the United States Court of Appeals for the Second Circuit was entered on June 19, 1964. The petition for certiorari was filed on September 11, 1964 and was granted on December 14, 1964. The jurisdiction of this court is invoked under 28 U. S. C. 1254 (1).

Questions Presented

1. Whether under the 1939 Internal Revenue Code gain realized on the sale of notes issued at a discount constitutes capital gain or ordinary income in the nature of interest?

2. Where the petitioners relied, in entering into a transaction, upon a Treasury position, evidenced by a published Acquiescence, in a decision of the Tax Court affirmed by the Sixth Circuit (*Commissioner* v. *Caulkins*, 144 F. 2d 482 (6th Cir., 1944), affirming 1 T. C. 656 (1943)), that original issue discount is, when realized by sale or exchange, capital gain, may the Commissioner thereafter to the detriment of the petitioners change his position retroactively and on a discriminatory basis and seek to tax such income as ordinary income in the nature of interest?

Statutes Involved

The relevant sections of the Internal Revenue Code of 1939 are Sec. 42(b), Sec. 42(c), Sec. 111(a), Sec. 117(a)(1), Sec. 117(a)(1)(D), Sec. 117(f), Sec. 125, Sec. 201(e), Sec. 207(d), Sec. 3791(b) and the relevant sections of the Internal Revenue Code of 1954 are Sec. 171, Sec. 483 and Sec. 1232. They are set forth at pages 37 to 47, *infra*.

Statement of the Case

Petitioners, members of the firm of Carl M. Loeb, Rhoades & Co., a partnership, instituted this action for the refund of income taxes and interest alleged to have been erroneously and illegally assessed and collected by the Government from them for the taxable year 1952.

During the c;alendar year 1952, the partnership * acquired certain securities consisting of 33 short-term non-interest bearing promissory notes which had been issued at a discount. (R. 28). The notes were purchased, either directly from the issuing obligor corporation or through agents or dealers, on the original date of issue in all but one instance (R. 28-29). The notes had been purchased by the partnership in reliance on the Commissioner of Internal Revenue's interpretation of applicable Sections of the Internal Revenue Code as evidenced by his published Acquiescence in the case of *Caulkins* v. *Commissioner*, 1 T. C. 656, aff'd 144 F. 2d 482 (6th Cir., 1944) (R. 32-34). In that case the Sixth Circuit held that gain realized upon redemption at maturity of a debt obligation in registered form issued at a discount is capital gain since section 117(f) made such redemption the equivalent of an exchange.

Immediately upon acquisition, the promissory notes were segregated and identified as held for investment in accordance with Section 117(n) of the Code (R. 29). From time to time during the year 1952, the partnership sold some of the promissory notes prior to maturity thereof after they had been held by the partnership for a period in excess of six months (R. 29).

The partnership reported the difference between the sales price and its cost as long term capital gain from the sale of capital assets, and the partners reported their respective distributive shares of said capital gain and paid the tax thereon (R. 29). The Commissioner disallowed the petitioners' capital gain treatment on the 1952 sale of the promissory notes, and ruled that discount is when realized ordinary income in the nature of interest (R. 30). The Commissioner computed the income realized as earned by virtue of the discount for each day that each of the 33 notes was held by the partnership both with respect to notes that were sold in 1952 and those unsold at the end of the year

* The argument refers to petitioners rather than the partnership since the former are the taxpayers and not the partnership.

(R. 30). This earned discount per day was then multiplied by the number of days that the notes were held, and the resulting amount was held ordinary income in the nature of earned interest, and each partner-petitioner was held taxable on his distributive share of such ordinary income (R. 30). The deficiencies were paid by the petitioners, claims for refund were filed and denied, and the petitioners thereafter instituted this action in the District Court (R. 30).

On cross-motions for summary judgment, the issues before the District Court were (1) whether the gain attributable to the original issue discount should, under the 1939 Code, be treated when realized by sale or exchange as ordinary income or capital gain and (2) whether in light of the consistent prior Treasury position as evidenced by the Acquiescence in *Caulkins* v. *Commissioner,* which recognized original issue discount when realized as capital gain, may the Treasury despite petitioners' reliance thereon, retroactively and on a discriminatory basis change its position to the detriment of petitioners (R. 5). The District Court granted the Government's motion for summary judgment and dismissed with prejudice the amended complaint of the petitioners (R. 2-3). The Court of Appeals affirmed (R. 50) and the petition for certiorari was granted on December 14, 1964 (R. 51).

Summary of Argument

I.

The first issue involves solely the proper construction of the Internal Revenue Code of 1939 since the taxable year before the Court is the calendar year 1952. As in all matters of statutory construction, the ordinary meaning of words is to be applied in the light of demonstrated Congressional intent and understanding.

A. There are in the Internal Revenue Code of 1939 several special sections which classify original issue discount as an income item. There is not to be found, however, any

section of general application comparable to Section 1232 of the 1954 Code which characterizes discount as other than a capital item, taxable as ordinary income when realized.

To the Court below the difference between the two Codes created no question. The Court's explanation was that the new section of the 1954 Code, for which no prior precedent existed, merely clarified existing law and did not alter it. It was this explanation which enabled the Court below to refuse to apply the provisions of the 1939 Code which recognize a capital gain when capital assets such as the securities here involved are sold at a profit.

The conclusion of the Court below that the 1954 Code merely clarified the prior law cannot be justified. Even the Second Circuit has subsequently changed this conclusion. In *Lubin* v. *Commissioner,* 335 F. 2d 209 (2nd Cir., 1964), decided less than two months after the within case and to which the 1939 Code also was applicable, the Second Circuit held that the discount at which certain securities, had been issued was not, under the facts of the case, when realized ordinary income in the nature of interest and was taxable as capital gains. In reaching its decision, the Court recognized that if the 1954 Code had been applicable, the gain attributable to the discount would have been taxed as ordinary income. Accordingly, to the Court in the *Lubin* case, the 1954 Code did modify prior law.

B. The position of the Court below cannot be upheld in the light of the legislative history concerning the status of discount. In connection with Revenue legislation under consideration in 1929, the Revenue Act of 1938, and even in connection with the enactment of Section 1232 of the Internal Revenue Code of 1954, as well as on other occasions, Congress has demonstrated its awareness of an existing difference in tax treatment between discount and interest. Not only are there these specific characterizations by Congress of discount as a capital item taxable as capital gain when

realized, but in addition, not one instance may be found in the legislative history prior to the 1954 Code wherein Congress has referred to discount as the equivalent of taxable interest or other ordinary income without special legislation, notwithstanding the full recognition of the economic relationship between discount and interest.

It is also clear that from time to time in its consideration of the status of discount in particular situations Congress has decided that discount should not be a capital item. Whenever Congress has come to this conclusion, it has enacted special legislation to classify discount in that situation as an income item and deny it capital gains treatment. Several such instances exist where Congress has enacted as part of the Revenue laws special legislation dealing with discount and providing designated treatment for discount in specified situations. Section 1232 of the 1954 Code is one example of such special legislation differing from the others as to scope in that now the general rule is changed and discount has become an income item unless the amount thereof does not exceed the limits set forth in this Section. The discount involved in the securities before this Court does not fall within any of such special legislative enactments prior to Section 1232 of the 1954 Code.

C. The relationship between yield or interest has already been considered by this Court and its decision therein should govern the disposition of the issue regarding discount. As obligations are from time to time issued at a discount, they are on occasion issued at a premium. The discount affects the "yield" or the amount of compensation paid for the use of money but so does the premium. And yet the Government, contrary to the position which it now takes as regards discount, has ruled that premium, unless there is a special statute, does not affect income but is to be taken into account only on sale or other disposition of the obligation. The Government position as regards premium has been sustained by this Court. *New York Life Insurance Co. v. Edwards*, 271 U. S. 109 (1926); *Old Colony R. Co. v. Commissioner*, 284 U. S. 552 (1932). Accordingly, premium

could affect income only by reason of special legislation which was enacted by Congress as Section 125 of the Internal Revenue Code of 1939. Moreover, under the statute amortization against income of premium on private securities is elective. Accordingly, if in 1952 petitioners held obligations some of which had been issued at a discount and others of which had been issued at a premium and had failed to make the election to amortize the premium, the Government would be in the strange position of contending that under the 1939 Code premium is not an income item but affects capital gain or loss, whereas discount as to which there is no applicable statutory provision—not even elective—is an income item and does not affect capital gain or loss.

The Court below did not attempt to reconcile its decision with the holdings of this Court as regards debt premium.

D. The Court below gave considerable weight to the argument that discount must be interest because it is compensation for the use of money. Equating compensation for the use of money and interest in this fashion is not sustained by the legislative history and the precedent in this Court which have already been described. As recently as last year Congress again recognized that compensation for the use of money is not the same as interest or an income item in the absence of special legislation. The Revenue Act of 1964 added Section 483 to the 1954 Code so as to establish an interest element in sales transactions calling for deferred payments but without expressed interest. Prior to this amendment of the Code no part of such deferred payments would have been taxed as interest even if a portion of the payments may have represented compensation for the use of money.

II.

In 1952 and for more than 30 years prior thereto the consistent administrative practice and interpretation of the 1939 Code and prior Revenue laws was that discount on pri-

vate securities was not interest but a capital item taxable as capital gain when realized by sale or exchange. Such questions as to discount as may have existed during this period were deemed answered when on December 25, 1944 the Commissioner of Internal Revenue published his Acquiescence in *Caulkins* v. *Commissioner,* 1 T. C. 656 (1943), aff'd 144 F. 2d 482 (6th Cir., 1944). This case involved the status of discount realized upon retirement of a security in registered form, which discount from the security itself was obviously compensation for the use of money in lieu of interest. Both the Tax Court and the Circuit Court held that profit attributable to the discount was not interest but capital gain.

The Acquiescence and the statute, so far as is here pertinent, continued undisturbed through five major legislative overhauls that took place between the date of the Acquiescence and the initiation of the transactions before this Court. Accordingly, in 1952 petitioners believed that the *Caulkins* Acquiescence represented the official interpretation of the statute as regards discount. In March 1955, the Government in a Revenue Ruling 55-136, 1955-1 Cum. Bull. 213, announced that the *Caulkins* case had been wrongly decided and that the Acquiescence was withdrawn. The Government is applying this change of position and interpretation retroactively to 1952.

Petitioners acted in reliance on the Treasury position as existing in 1952 and have been harmed by the retroactive application of the changed position regarding discount. The Court below held that petitioners could not complain because the Government may always correct a mistake of law and apply such correction with retroactive effect. The authority cited is the decision of this Court in *Automobile Club of Michigan* v. *Commissioner,* 353 U. S. 180 (1957).

It is true that this Court held in the *Automobile Club of of Michigan* case that Section 3791(b) of the 1939 Code give the Government the power to determine whether a ruling

should be applied without retroactive effect and therefore confirms the power to apply rulings retroactively, and that the Government may correct a mistake of law. However, the *Automobile Club of Michigan* case not only represents the most recent consideration by this Court of the subject matter but also recognizes that the Government is under an obligation properly to apply the power given it in Section 3791(b); otherwise, an abuse of discretion will exist. Whether or not there has been a proper exercise of the power will depend on the "circumstances" of the case. 353 U. S. at page 184.

This Court's delineation of "circumstances" which sustain retroactive application of a change of position or correction is therefore of major significance to the determination of this issue. The standards which were thus accepted provide a basis for determining whether the Government has acted properly when applying to the year 1952 the position taken by it in subsequent years.

The Automobile Club of Michigan had complained that, although its exemption rulings had been revoked in 1945, the Treasury was assessing tax for 1943 and 1944. However, this Court pointed out that an Internal Revenue Service General Counsel's Memorandum had been published in 1943 which had made clear to all clubs such as the Automobile Club of Michigan that tax exemptions previously allowed were in error. Accordingly, the Automobile Club of Michigan was on notice in 1943 that it was no longer deemed exempt and accordingly should have anticipated a tax liability for that year and thereafter. This position thus taken in 1943 had been uniformly applied. All automobile clubs were similarly treated; there was no discrimination in favor of one club as against another. The exempt status of all such clubs had been revoked as of 1943 and taxes were assessed as against all clubs commencing with that year. Under such "circumstances" application of the 1945 revocation to 1943 and 1944 was to be upheld.

In this case petitioners had no notice in 1952 of any contemplated change of position. Petitioners could have no knowledge that the *Caulkins* Acquiescence was to be withdrawn and the Treasury practice which it evidenced, abandoned. Moreover, the Automobile Club of Michigan apparently took no steps in 1943 and 1944 by way of choice among available courses of action because of the rulings later revoked, whereas petitioners did acquire the securities in reliance on the Government's position in 1952 as well as prior thereto regarding discount.

The withdrawal of the *Caulkins* Acquiescence and the change of position was not retroactively applied as regards persons who had purchased Accumulative Installment Certificates from Investors Services (the particular security involved in the *Caulkins* case) during the period December 25, 1944, the date of the *Caulkins* Acquiescence, and the date when the Acquiescence was withdrawn. At the same time it was acknowledged by the Treasury that there was no basis to distinguish the discount in the *Caulkins* type security from the discount involved ordinarily in any obligation. Accordingly, applying the principle established in *Automobile Club of Michigan,* there is here no dealing with all taxpayers "upon the same basis" which that case emphasizes as an appropriate standard. 353 U. S. at page 186. Without reason taxpayers who in this period purchased a particular discount security are favored against taxpayers who like petitioners in the same period acquired other discount securities.

In *Automobile Club of Michigan,* the "circumstances" showed no abuse of discretion. However, the Federal courts in following *Automobile Club of Michigan* are to examine the circumstances of the retroactive application of a change of position and then determine whether there has been an abuse of discretion or a proper exercise of power. So far as can be ascertained from the opinion below, the Second Circuit made no such examination and

nevertheless sustained the manner in which the change of position was retroactively applied to 1952.

The Government apparently believes that it may retroactively change its position in a non-uniform and discriminatory manner. Such a position, if upheld, will greatly impede business planning. Administrative law cannot approve administrative actions arbitrarily and selectively imposing tax consequences officially disclaimed and therefore not foreseeable when the transactions were undertaken. Taxpayers and their advisors should be permitted and encouraged to rely on published pronouncements of the Government and to be certain that they will be treated no less favorably than any other taxpayer similarly situated.

POINT I

Under the 1939 Internal Revenue Code original issue discount is when realized upon sale taxable as capital gain unless otherwise specifically provided.

A. The Applicable Sections of the 1939 Code Unlike the 1954 Code Provide Capital Gain Treatment for Discount.

A capital gain is realized pursuant to the 1939 Code when a capital asset is sold or exchanged for a price in excess of its cost. Section 111(a).[1] Capital assets are defined in Section 117(a) and based upon the statute, the securities here involved were capital assets. It is also undisputed that the securities were sold and that a price in excess of cost was received and that the gain was reported as a capital gain.

Such statutory provisions as exist in the 1939 Code uphold petitioners' reporting of the transactions before this Court. And yet the Court below denies petition-

[1] All Internal Revenue Code references are to the 1939 Code unless otherwise stated.

ers' capital gain treatment on the ground that original issue discount is always an income item in the nature of interest and when realized must remain ordinary income and not capital gain (R. 47). No statutory provision is or could have been cited to support the holdings.

It is not until 1954 that a statutory provision (Section 1232 of the 1954 Code) was enacted to change the general rule and classify discount as an income item. This provision is by its terms applicable only to securities issued after December 31, 1954.

The Court below was aware that in the 1939 Code there was no provision comparable to Section 1232 of the 1954 Code. The difference between the two Codes was explained on the ground that the 1954 Code only clarified the law and did not revise existing law (R. 49).

However, the addition to the 1954 Code of a special section not found in the 1939 Code which, like the decision below, classifies discount as an income item, at the very least persuasively indicates that different tax results exist under the two Codes. The explanation of the Court below should therefore be accepted only if clearly supported, and this is not the case.

As is fully developed hereafter, this explanation is contradicted by the understanding and intent of Congress in connection with the Revenue laws prior to the 1954 Code, that discount, unless specific legislation to the contrary exists, is a capital item. Under Section 1232 of the 1954 Code gain attributable to discount is not termed interest but placed in the category of ordinary income through classification as gain from the sale of a non-capital asset. Furthermore, unlike the decision below, the 1954 Code does not remove all discount from the capital item classification. If the amount thereof does not exceed the limits placed in section 1232 (b)(1) of the 1954 Code, then discount when realized remains capital gain.

It is also significant that the Second Circuit subsequently departed from the conclusion that the 1954 Code merely clarified existing law. In *Lubin* v. *Commissioner*, 335 F. 2d 209 (2nd Cir., 1964) it was held that under the facts in that case the gain attributable to discount realized on retirement of certain registered obligations was not interest but a capital item and therefore taxable as capital gain. The Court, however, stated that this result could exist only under the 1939 Code and that had the 1954 Code provisions been applicable, the discount when realized would have constituted ordinary income (335 F. 2d at p. 212, n. 3). Accordingly, there is recognition in the *Lubin* case that the 1954 Code did revise previously existing law.

B. Legislative History Demonstrates That Congress Understood and Intended That Under the 1939 Code Discount in the Circumstances of This Case is a Capital Item Taxable as Capital Gain When Realized by Sale.

The history of Congressional treatment of original issue discount for tax purposes is replete with evidence that Congress has been fully cognizant of the relationship between discount and interest and has repeatedly made a deliberate distinction in the tax treatment of each. This is found in the several occasions when Congress considered the status of original issue discount prior to, as well as at the time of, the enactment of the 1954 Code. In each instance Congress has recognized that original issue discount is a capital item taxable as capital gain when realized unless Congress has legislated to the contrary. This recognition exists both in express Congressional statements as well as in the fact that there has been specific legislation whenever Congress concluded that in a particular situation capital gain treatment for discount was not warranted and should be replaced by ordinary income treatment.

Congressional understanding that discount is a capital item is found in the course of the consideration given by Congress in 1929 to the authorization of the issue of non-interest-bearing United States discount obligations. The Treasury had proposed that any gain from the sale of these obligations be exempt from tax. It is evident from the Congressional Record that opposition developed because the Senate was of the opinion that discount when realized is capital gain and did not wish to set any precedent which would exempt any capital gain from tax even if arising from Government obligations the interest on which was exempt from tax. June 4, 1929, Congressional Record, Senate, pp. 2319-2333. It is also apparent from the debate that the Senate Finance Committee had been advised by the Treasury that under its interpretation of the statutes discount when realized was a capital item. Senator Couzens of Montana stated:

> "The Undersecretary of the Treasury stated before the Finance Committee that the same identical bills of indebtedness when traded in commerce, are subject to a profit tax. When a bill is traded in commerce, an acceptance, or what not, if there is a capital gain, it is taxed." June 4, 1929, Congressional Record, Senate, p. 2330."

During the same debate, Senator Reed of Pennsylvania expressed the prevailing Congressional opinion of the status of discount as follows:

> "Mr. President, it seems to me that these questions have brought the issue down to the real point. What actually happens in the case of the transaction described by the Senator from Montana is that a negotiable instrument [a discount obligation] is bought at one price, and subsequently sold at another; and the profit, taken in connection with the time the bill is held, is capital gain which is the equivalent of interest on that money." June 4, 1929, Congressional Record, p. 2331.

In other words, it is recognized that discount though compensation for the use of money is when realized on sale taxable as capital gain and not as interest.

Congress resolved the problem before it in 1929 by enacting a statute, presently Section 754(b) of Title 31 U.S.C., which specifically provides that discount on non-interest-bearing U. S. obligations is interest. In this manner, the discount on the newly-authorized United States obligations was made subject to the exemption from tax then applicable to interest paid on obligations of the United States.

The legislative developments in connection with the Revenue Act of 1938 reiterate Congressional understanding that discount absent specific legislation is a capital item. Congress at that time was investigating a suggested change in the tax laws to eliminate the taxation of capital gains. The Subcommittee of the Committee on Ways and Means which was appointed to consider the proposal recommended that no such change be made. A primary reason advanced by the Committee for its recommendation against exemption of capital gains from taxation was that it would permit discount like other capital gains to escape taxation. The report of this Subcommittee shows that the treatment of discount as a capital gain item was known to the Congress and accepted by it as well as was the relationship between discount and interest and the existence of a deliberate difference in tax status:

> "It is important also to emphasize that there is no clean separation in practice, between capital gains and ordinary income; and that the complete exemption of capital gains from income taxes might well stimulate the conversion of other types of income into the form of capital gains. For instance, mortgages, land contracts, etc., are frequently sold at substantial discounts. From a statutory standpoint, the difference between the principal amount and the purchase price is regarded as a capital gain; but from an economic standpoint the discount is

> merely the means whereby the effective annual yield of the instrument is raised from, say, 6 percent to 12 or 15 percent. A bond purchased at a premium results in a capital loss when redeemed at par, and a bond purchased at a discount, is a capital gain. Yet it is the everyday practice in investment circles to quote both these types of bonds in terms of their effective yields to maturity or call date. Consequently, elaborate provisions in the statute, the effective administration of which would be impossible or extremely difficult, would be necessary, if the income tax were removed from capital gains, in order to prevent widespread avoidance of the income-tax burden through manipulation of ordinary income into the guise of capital gain." Report of Subcommittee of Committee on Ways and Means, 75th Cong. 3rd Sess. dated January 14, 1938. Reported in Hearings on H. R. 9682, 75th Cong. 3rd Sess., p. 38.

The enactment of the 1954 Code and the special classification in Section 1232 thereof of discount as an income item was accompanied with re-affirmation of the capital gains status of discount under prior law. The report of the House Ways and Means Committee in connection with the 1954 Code stated:

> "Under existing law any gain realized from a corporate or Government bond in registered form or with coupons attached is treated as a capital gain either if the bond is held to retirement or it is sold or exchanged. Part or all of this gain, however, may represent discount on original issue which is a form of interest income and in fact is deductible as an interest payment by the issuing corporation.
>
> "Effective with respect to bonds issued after December 31st, 1954, the committee bill provides that any gain realized by the holder of a bond attributable to the original issue discount will be taxed as ordinary income * * *." H. Rep. No. 1337, 83rd Cong., 2d Sess. p. 83 (3 U. S. C. Cong. & Adm. News (1954) 4017, 4110)

Legislative understanding is clearly reflected in the special actions taken by the Congress whenever it was desired to make of discount an income item and subject to ordinary income treatment. There are accordingly, many instances of statutory enactments prior to 1954 which would have been superfluous had it been the understanding and intention of Congress that original issue discount is always an income item rather than a capital item. Instances of such statutory enactments regarding discount include the following sections of the 1939 Code:

> Section 117(a)(1)(D)—making discount on the securities there enumerated an income item by excluding these securities from the definition of capital assets.
>
> Section 42(b)—allowing an election to report annually increases in the value of discount obligations limited, however, to the type specified therein.[2]
>
> Section 42(c)—postponing realization of income from short-term Government discount obligations until disposition.
>
> Section 201(e)—requiring accrual of bond discount and amortization of bond premium on all obligations but only for life insurance companies.
>
> Section 207(d)—requiring accrual and amortization respectively of discount and premium on all obligations but only for certain mutual insurance companies.

[2] U. S. Savings Bonds are of course the typical obligation covered by this section. It is therefore of considerable interest that in 1948 there was introduced in Congress H. R. 6999 the avowed purpose of which was to provide capital gains treatment for United States obligations issued at a discount comparable to the capital gains treatment available for private securities issued at a discount. 26 Taxes 775 (1948).

Discount in principle is of course no different for present purposes than premium.[3] Both are equally concerned with compensation for the use of money and have been so recognized by this Court. *Old Colony R. Co.* v. *Commissioner*, 284 U. S. 552, 558-9 (1932). Yet it required the enactment of a special statute (Section 125 of the 1939 Code) to permit the amortization of premium in order to achieve a "true" interest yield; and even this is permitted only on an elective basis.

There is yet further proof of Congressional understanding that discount is a capital item unless contrary specific legislation exists. For more than 30 years prior to the 1954 Code it had been the practice of the Treasury (and the Revenue laws were so interpreted)[4] to treat original issue discount as a capital item and not as interest unless the Revenue laws provided otherwise.[5] During this period there are many statutory re-enactments, including the 1939 Code. In fact, between December 25, 1944 the date of the Acquiescence in *Caulkins* v. *Commissioner*, I. T. C. 656 aff'd 144 F. 2d 482 (6th Cir., 1944)[6] and January 1, 1952, there are five statutory overhauls of major significance,[7] and at no time did Congress seek to change the rule

[3] The relationship between premium and discount and the holdings of this Court in connection with premium are more fully discussed at pages 21-24, *infra*.

[4] Pages 26-29, *infra*.

[5] An exception to the practice existed as regards discount on state and municipal securities. G. C. M. 21890, 1940-1 Cum. Bull. 85. However, the considerations connected with state and municipal obligations where there are constitutional implications are completely different from those existing with regard to private securities.

[6] The *Caulkins* case held that discount when realized on retirement of a registered obligation is a capital gain and the Government Acquiesced. The case and the Acquiescence are discussed at pages 26-29, *infra*.

[7] The Revenue Acts of 1945, 1948, 1950 and 1951 and the Technical Changes Act of 1949.

governing the tax treatment of discount (nor did the Treasury apparently request any change). Under such circumstances, this Court has repeatedly held that not only is there a clear demonstration of Congressional intent, but the equivalent of Congressional approval and an express statutory enactment:

Thus, in *Helvering* v. *Winmill,* 305 U. S. 79 (1938) this Court stated (p. 83):

> "Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially re-enacted statutes, are deemed to have received congressional approval and have the effect of law."[8]

With one exception, the legislative history which has been set forth, has apparently not been taken into consideration or given any weight by the Courts which have recently reviewed the status of discount under the 1939 Code. The exception is found in the opinion of Judge Kalbfleisch in *Midland-Ross Corporation* v. *United States,* 214 F. Supp. 631 (N. D. Ohio, 1963), aff'd 335 F. 2d 561 (6th Cir., 1964),[9] and he concluded that discount is a capital item unless special legislation to the contrary exists.

The legislative history to which the Court below refers to demonstrate Congressional intent is limited to the report of the Senate Finance Committee in connection with Section 1232 of the 1954 Code. This report is cited to show that the 1954 Code merely clarified existing law as regards discount without changing it because it is stated in the Report that "there is some uncertainty" as to the status of discount when realized and that effective with respect to obligations issued after December 31, 1954 the uncer-

[8] See also *Massachusetts Mutual Life Insurance Co.* v. *United States,* 288 U. S. 269, 273 (1933); *Brewster* v. *Gage,* 280 U. S. 327, 337 (1930).

[9] In its *per curiam* affirmance the Sixth Circuit termed the opinion of Judge Kalbfleisch "comprehensive."

tainty is removed by taxing the gain attributable to original issue discount as ordinary income. S. Rep. No. 1622, 83rd Cong., 2d Sess., p. 112 (3 U. S. C. Cong. & Adm. News (1954) 4621, 4745).

The Senate Report cannot dispose of the unbroken chain of legislative history, including the House Ways and Means Committee Report in connection with the same statute, that discount under the 1939 Code was not an income item. The Senate Report does not state that the ordinary income treatment in the 1954 Code is declarative of existing law but on the contrary expressly disclaims retroactive intent. Furthermore, the references to show "some" uncertainty demonstrate that the Committee was not fully informed. For this purpose the Report compares *Commissioner* v. *Caulkins* (without mentioning the Acquiescence) and I. T. 3486 1941-2 Cum. Bull. 76. There is no basis for this comparison. *Commissioner* v. *Caulkins* clearly held that discount is a capital item taxable as capital gain when realized. I. T. 3486 merely pointed out that since original issue discount on certain United States obligations was expressly treated as interest by statute (now Section 754(b) Title 31 U. S. C.) the elimination in 1941 of tax exemption for interest on United States securities was applicable to any such discount as well as to expressed interest. A ruling issued under a specific statute which was required and therefore enacted in order to treat discount as interest supports the *Caulkins* treatment of discount as a capital item rather than throws doubt upon it, and by no means creates uncertainty.

Legislative intent is certainly not demonstrated by a Congressional Report which refers to "some" doubt and which is contradicted by the contemporaneous report in the other legislative chamber. Legislative intent can be found in the long-standing and consistent legislative history which directly and unequivocally classifies discount as a capital gain when realized by sale or exchange.

C. The Holding Below That Discount is an Income Item Taxable as Interest Because it is Compensation for the Use of Money is in Conflict With the Decisions of This Court Concerning Bond Premium and Cannot Be Sustained.

Prior to the amendment of the 1939 Code which added Section 125 the Government took the position that bond premium could not be amortized against income. This position was taken despite the fact that premium directly affects the amount of compensation received for the use of money; to the extent that the lender pays a premium the effective interest rate received by him is reduced. Since the Government is contending that discount is an income item in the nature of interest because it represents compensation for the use of money, then it should have recognized that premium is likewise a part of the determination of the amount of compensation received for the use of money and therefore always an income item. Had the statute not been changed to permit premium amortization against income, the Government would now be arguing inconsistently that interest income is realized from discount although unaffected by premium. Even at present if a taxpayer fails to make the election under Section 171 of the 1954 Code (formerly Section 125 of the 1939 Code), the Government would contend that as regards this taxpayer premium remains a capital item.

The Government's position that premium is a capital item, contrary to its position here as regards discount, was upheld by this Court in *New York Life Insurance Co.* v. *Edwards*, 271 U. S. 109 (1926). This holding should be accepted as recognizing that although an item may have a direct relationship with compensation for the use of money, it is not necessarily an income item.

In *Old Colony R. Co.* v. *Commissioner*, *supra*, this Court again considered the relationship between interest, premium and discount. The question before the Court

was whether in determining the interest deduction, premium should be applied as a pro rata offset. In holding that the premium in that case need not be thus applied, this Court stated that the concept of an imputed or "effective" interest rate has no place in tax law. The Court recognized "that the actual return to one who pays a premium is less than the nominal interest carried by the bond and to one who buys it a discount is greater than such nominal rate." 284 U. S. at 558. Although "effective rate" may have a place in accounting, it is not relevant for tax purposes. Had Congress intended to incorporate such concepts into the Revenue law, it would have so provided.[10]

The Government's position in this case is accordingly based on theories which this Court has rejected. Discount may be compensation for the use of money and part of the financial determination of the effective rate or yield, but it is not by reason thereof an income item. The law as settled by this Court in the cases dealing with bond premium cannot be reconciled with the decision of the Court below and it is significant that the Court attempted no such reconciliation;[11] so long as specific legislation is required to make of

[10] There are more recent decisions of this Court which follow the same basic approach: *Commissioner* v. *Korrell,* 339 U. S. 619 (1950) (premium paid for a conversion privilege could be amortized under Section 125 prior to amendment even though not economically concerned with the use of money); *Hanover Bank* v. *Commissioner,* 369 U. S. 672 (1962) (bond premium amortization based on special call price which probably would not be used was permitted although the effective interest rate was thereby distorted).

[11] The Second Circuit did refer to the *Old Colony R. Co.* case in *Lubin* v. *Commissioner,* 335 F. 2d at 213 when deciding that the discount in that case was a capital item. The *Old Colony R. Co.* case is cited as authority for the rule that not all discount is interest since the "term 'interest' when used by Congress is to be construed according to 'the usual, ordinary, and everyday meaning of the term' and not according to 'some esoteric concept derived from subtle and theoretic analysis'."

premium an income item, as this Court held, then also special legislation is required to make of discount an income item.

The foregoing also demonstrates the fallacy of the Government's argument accepted by the Court below, that a one-year note for $10,600 issued for $10,000 must in tax effect be identical with a $10,000 note of like duration issued with 6% stated interest. This example, at most, reiterates that discount is compensation for the use of money. In the light of the cases in the Court dealing with bond premium the example has no meaning for tax purposes. Otherwise, even without special legislation the tax result to the holder of a one-year obligation for $10,000 should be the same regardless of whether it was issued at a $300 premium for $10,300 with stated interest at 6% or for par with stated interest of 3%.

The weakness of this Government argument is also demonstrated by recent legislative history in connection with the Revenue Act of 1964. Recognizing that an interest rate cannot be imputed or made effective where none is expressed, the Courts have held that if a capital asset is sold for $11,000 payable in 2 years without interest, the entire gain was capital even though were the price stated as $10,000 payable in 2 years with interest at the rate of 5% per annum the capital gain is to be based on the $10,000 price and the 5% is to be taxed as interest.[12] It required the enactment of a special statute so that the element of compensation for the use of money which was clearly present could be taxed as interest. Section 483 of the 1954 Code as added by Section 224 of the 1964 Revenue Act. The report

[12] In *Kingsford Co.* v. *Commissioner,* 41 T. C. 646 (1964) the agreement of sale specifically stated that the price included both principal and interest and yet the Tax Court refused to find taxable interest because no interest rate had been expressed. And the Treasury has very recently accepted this decision as correct by its Acquiescence in the case. 1964 IRB No. 51 at page 6.

of the House Ways and Means Committee states the prior law and the reason for the change:

> "Your Committee sees no reason for not reporting amounts as interest income merely because the seller and purchaser did not specifically provide for interest payments. This treats taxpayers differently in what are essentially the same circumstances merely on the grounds of the names assigned to the payments. In the case of depreciable property this may convert what is in reality ordinary interest income into capital gain to the seller. At the same time the purchaser can still recoup the amount as a deduction against ordinary income through depreciation deductions. Even where the property involved is a non-depreciable capital asset, the difference in tax bracket of the seller and buyer may make a distortion of the treatment of the payments advantageous from a tax standpoint * * *." H. Rep. No. 749, 88th Cong., 1st Sess. p. 72.

D. The Authorities Cited by the Court Below and by the Other Courts Which Have Reached the Same Result Are Not in Point.

The question before this Court has been considered by other constitutional courts beside the Second Circuit.[13] Apart from the decision of the Sixth Circuit in *Midland-Ross Corporation* v. *United States,* 214 F. Supp. 631 (N. D. Ohio, 1963), aff'd 335 F. 2d 561 (6th Cir., 1964), all have reached results adverse to the taxpayers. As authority, however, each such Court apart from citing a prior decision in another Court on the question relies on authorities that are not in point and in addition does not discuss the relevant legislative history.

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[13] *Commissioner* v. *Morgan,* 272 F. 2d 936 (9th Cir., 1959); *Rosen* v. *United States,* 288 F. 2d 658 (3rd Cir., 1961); *United States* v. *Harrison,* 304 F. 2d 835 (5th Cir., 1962), cert. denied, 372 U. S. 934 (1963); *Pattiz* v. *United States,* 311 F. 2d 947 (Ct. Cl., 1963); *Real Estate Investment Trust of America* v. *Commissioner,* 334 F. 2d 986 (1st Cir., 1964).

The Circuit Court decisions repeatedly cited are *Jaglom* v. *Commissioner*, 303 F. 2d 847 (2nd Cir. 1962) and *Fisher* v. *Commissioner*, 209 F. 2d 513 (6th Cir.) cert. denied 347 U. S. 1014 (1954). Both of these cases are concerned with taxation of expressed interest when realized upon a sale and not with discount and can be material only if the conclusion is assumed that discount is an income item in the nature of interest—the very point at issue here.

The holdings of this Court frequently cited are *Commissioner* v. *P. G. Lake, Inc.*, 356 U. S. 260 (1957), *Commissioner* v. *Horst*, 311 U. S. 122 (1940), *Deputy* v. *DuPont*, 308 U. S. 448 (1940). These cases likewise are not relevant to the issue. The *Lake* and *Horst* cases are concerned with the disposition only of a right to income apart from the capital asset and conclude that the realization under such circumstances cannot be capital. There has been no comparable retention here. *Deputy* v. *DuPont* involved the status of amounts required to be paid the lender of stock in connection with a short sale measured by dividends paid during the period of the loan. This Court held that such payment was not interest for tax purposes and defines interest as compensation for the use of money. That is not, however, the issue in this case.[14]

[14] In *Lubin* v. *Commissioner* the Second Circuit characterized the definition of interest in *Deputy* v. *DuPont* as "while useful as a starting point [it] is not dispositive of the issue before us nor can it be." (335 F. 2d at p. 213.)

POINT II

The Government should not be permitted retroactively to change on a discriminatory basis its position as regards original issue discount, which position is evidenced by the Acquiescence in *Caulkins* v. *Commissioner*, to the detriment of the petitioners who relied on such position.

A. During 1952 and for More Than 30 Years Prior Thereto the Government's Position Was That Original Issue Discount Was a Capital Item and When Realized by Sale or Exchange Taxable as Capital Gain.

In 1944 the Sixth Circuit affirmed the Tax Court and held that discount when realized by retirement of a registered obligation[15] is a capital item and not an income item. *Caulkins* v. *Commissioner*, 1 T. C. 656 (1943), aff'd 144 F. 2d 482 (6th Cir., 1944). The Treasury promptly acquiesced 1944 C. B. 5 (1944).

The Acquiescence was no surprise. Commencing in 1920 and without interruption the Treasury, as the occasion was presented for ruling, took the position that original issue discount on private securities was a capital item. It is set forth basically as early as 1920 in O. 1024, 2 Cum. Bull. 189 (1920). This ruling holds that original issue discount is not interest and therefore not subject to the withholding provisions when the security is owned by a non-resident alien taxpayer. In the ruling itself it is recognized that the discount is "compensation for the use of money and as such resembles interest" but it is ruled "such discount is not 'interest' * * *." In the same year in O. D. 475, 2 Cum. Bull. 211 (1920) discount as well as premium are held capital items:

> "Amortization of premium or discount on bonds as contemplated in Articles 544, 563 and 848, Regu-

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[15] Pursuant to section 117(f) retirement of a registered obligation is the equivalent of the exchange of that obligation.

lations 45 (dealing with the debtor's tax treatment), is not permissible in the case of the purchaser of bonds. The purchase price of the bond, even though different from par represents the investment. When the bonds mature or are sold the basis for determining the gain or loss is their purchase price, or their fair market value as at March 1, 1913, if acquired prior to that date."

In 1922 the position taken in O. 1024, *supra*, was reaffirmed in I. T. 1398, I-2 Cum. Bull. 149 (1922).

In 1927 the Treasury argued before the Tax Court, and was upheld, that bond discount as well as bond premium were capital items to be reflected only in the determination of the amount of gain or loss realized upon the disposition of the securities involved. *Corn Exchange Bank* v. *Commission*, 6 B.T.A. 158 (1927).

Even the institution of the Caulkins litigation represented no break in the Government's thinking. The primary point argued before the Tax Court in this case was that the securities at issue were not eligible on retirement for the capital gain treatment provided in Section 117(f), that these securities were not in proper form and that therefore the increment was ordinary income taxable as interest. In fact, the Government attorney admitted in the Tax Court that in the absence of specific legislation even the increment on United States savings bonds issued at a discount would have been capital gain (1 T. C. 656, 662).

The significance of the Acquiescence in the Caulkins case cannot be over-emphasized. To the tax practitioner and the businessman an Acquiescence is a most important expression of official interpretation and position. Added to the prior consistent Government pronouncements, the Caulkins Acquiescence was surely deemed dispositive of any question about the status of discount. The impact of this Acquiescence was all the greater because the Cir-

cuit Court, in its opinion in the *Caulkins* case, expressed reservations about the result and invited legislative review of the issue.[16]

In addition, in the years following the Caulkins Acquiescence, the Treasury apparently continued to issue private rulings consistent with its prior practice and the Acquiescence.[17] Almost contemporaneously with the initiation of the transactions before the Court, the Treasury again on March 12, 1952 ruled that original issue discount is not an income item in the nature of interest and any tax liability with respect thereto was as a capital gain.[18]

On July 6, 1953, shortly before public consideration of the 1954 Code commenced, the Commissioner published Revenue Revuling 119 (1953-2 Cum. Bull. 95), the so-called Israeli Bond Ruling.[19] The ruling recognizes that the State

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[16] Text writers during the period following the *Caulkins* case had little question but that discount was a capital item in the absence of legislation and that such was the accepted government view. 4 Mertens, Law of Federal Income Taxation, Sec. 23, p. 162 n. 31, Paton, Advanced Accounting 196 (1941); Accountants Handbook, 483 (3rd Ed. 1943); Newlove, Intermediate Accounting, 205 (1939 Ed.); Lawrence, Bond Discount Treatment under the 1942 Revenue Act, 21 Taxes 61 (1943).

[17] 26 Taxes 775 (1948).

[18] 5 CCH 1952 Stand. Fed. Tax Rep. par. 6161. The application for ruling at 5 CCH 1952 Stand. Fed. Tax Rep. par. 6284 makes it clear that the securities involved had been issued at a discount. The March 12, 1952 ruling holds that there need be no withholding despite discount if the securities are held by a non-resident alien since discount is not interest but points out that by reason of Section 211(a)(1)(B) as amended by the 1950 Revenue Act, gain on sale prior to maturity may be subject to capital gains taxation.

[19] In the years between December 25, 1944, the date of the Caulkins Acquiescence, and July 9, 1953, the date of the Israeli bond ruling (Revenue Ruling 119, 1953-2 Cum. Bull. 95), the Government in litigation before the Tax Court raised the question of the treatment of discount. In each instance, however, the question was not on the ground that discount was an income item but either on the ground

of Israel bonds are similar to United States Savings Bonds and states that there is no basis to distinguish or tax differently the discount involved in the Israeli bond from that of the United States bond. The *Caulkins* case and the Acquiescence are referred to and are henceforth to be limited to what was decided under the facts of that case. The Caulkins Acquiescence is, however, not withdrawn.

The present Treasury position as regards discount under the 1939 Code was published on March 11, 1955 in Revenue Ruling 55-136 (1955-1 Cum. Bull. 213). In this ruling the Caulkins Acquiescence is withdrawn and it is stated that discount is when realized an income item.

The importance to taxpayers of Treasury practice and interpretation can hardly be overstressed. The tax statutes are complex and they affect materially most transactions. Petitioners purchased the securities here involved in reliance on the Government's position regarding discount as it existed in 1952. In like fashion numerous transactions are planned and consummated in the light of existing Treasury interpretations of the tax laws. If it is held that Treasury practice and published rulings of long standing may be given no weight, substantial harm and disruption will ensue.

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that the obligations were not in registered form (*Timkin* v. *Commissioner,* 6 T. C. 483 (1946), Acq. 1946-2 Cum. Bull. 5; *Carl Oestreicher, Trustee* v. *Commissioner,* 20 T. C. 12 (1953), Acq. 1953-2 Cum. Bull. 5) or on the ground that the transaction did not constitute a sale or exchange within the meaning of Section 117(f) (*Timken* v. *Commissioner, supra; Klein* v. *Commissioner,* 15 T. C. 26 (1950), Acq. 1950-2 Cum. Bull. 3; *Avery* v. *Commissioner,* 13 T. C. 351 (1949), Acq. 1950-1 Cum. Bull. 1).

B. The Government Changed its Position as Regards Original Issue Discount and Withdrew the Caulkins Acquiescence Subsequent to the Acquisition and Sale of the Securities Here Involved and Under Circumstances of This Case Should Not Be Permitted to Apply Such Change of Position and Withdrawal of Acquiescence Retroactively Against Petitioners Who Had Acted in Reliance on the Prior Position and the Acquiescence.

The Government first withdrew the Caulkins Acquiescence in 1955. Petitioners purchased and sold the securities in 1952. These securities were acquired because petitioners understood that it was the Government's position at that time and for many years prior thereto (as evidenced in the Caulkins Acquiescence) that discount was when realized a capital and not an income item.

Acquiescences are published by the Government in the Cumulative Bulletin, an official publication of the Treasury Department. In 1952 that part of the Cumulative Bulletin which contains Acquiescences stated:

> "In order that taxpayers and the general public may be informed whether the Commissioner has acquiesced in a decision of The Tax Court of the United States disallowing a deficiency in tax determined by the Commissioner to be due, announcement will be made in the Internal Revenue Bulletin at the earliest practicable date. (No announcements are made in the Bulletin with respect to memorandum opinions of the Tax Court.) Notice that the Commissioner has acquiesced or nonacquiesced in a decision of the Tax Court relates only to the issue or issues decided adversely to the Government. Decisions so acquiesced in should be relied upon by officers and employees of the Bureau of Internal Revenue as precedents in the disposition of other cases."

It is significant that the reference is to the "issue or issues" decided in the case which has been acquiesced. Whether or not the facts are in every respect identical is not

material. It is sufficient if the issue which could be involved in a contemplated transaction is the same as that involved in an Acquiescence. By Acquiescence in the Caulkins decision the Government gave its answer to the issue regarding the status of discount. The issue which could be involved in the securities before this Court was the same as in the Caulkins case: In the event of sale or exchange of the securities would the discount at which they were issued constitute a capital item or an income item. This issue was deemed answered, and petitioners so believed, by the Caulkins Acquiescence.

Nevertheless, after the initiation and completion of the transactions before this Court the Government changed its position and is now asking to apply that change of position retroactively as against petitioners who had acted in good faith and without any prior notice of a change of position impending or consummated.

The Second Circuit allows the retroactive application of the change of position on the ground that " 'the doctrine of equitable estoppel is not a bar to the correction by the Commissioner of a mistake of law' *Automobile Club of Michigan* v. *Commissioner,* 353 U. S. 180, 183 (1957)" (R. 49). The Court also observes that it would be "unduly harsh" to hold that if the Commissioner of Internal Revenue misinterprets the law, the Government is forever barred from collecting the taxes due (R. 49).[20]

However, this Court has recognized in *Automobile Club of Michigan* that whether retroactive application of a cor-

[20] The question of reliance on the Caulkins Acquiescence and the propriety of application of the Government's change of position was considered by two other Circuit Courts. In *Commissioner* v. *Morgan,* 272 F. 2d 936 (9th Cir., 1960) the Court observed that the taxpayers were not prejudiced since the securities there involved had been purchased well before the *Caulkins* decision and the Acquiescence. In *Rosen* v. *United States,* 288 F. 2d 658 (3rd Cir., 1961), the Court likewise observed that the taxpayers had no basis for complaint because of the change of position since the securities there involved had been acquired before 1944.

rection or of a change of position is to be sustained, depends on the "circumstances of the case" (353 U. S. at p. 184). It is pointed out that the Commissioner has the power under Section 3791(b) to determine whether any ruling should be applied without retroactive effect and that circumstances may exist where, if this power is not exercised, there will be an abuse of discretion, in which event retroactive application will not be upheld.[21]

It is therefore material to examine the facts in *Automobile Club of Michigan* and compare them with the facts in this case. This examination and comparison demonstrates that, whereas there was no abuse of power when the correction in that case was applied retroactively, the "circumstances" of this case are significantly different.[22]

In 1934 and again in 1938 the Commissioner of Internal Revenue had ruled that the Automobile Club of Michigan was exempt from Federal income taxes. In 1945 these rulings and the exemption were revoked and the revocation retroactively applied to 1943 and 1944 and deficiencies in taxes assessed for these years. The Automobile Club argued that this retroactive application of a change of position should not be permitted.

However, the revocation of the ruling issued the Automobile Club was the consequence of a Memorandum of the General Counsel of the Internal Revenue Service, which Memorandum interpreted the applicable 1939 Code provi-

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[21] As an example of an instance where under the circumstances of the case retroactive application of a change of position should not be approved, this Court cited *Lesavoy Foundation* v. *Commissioner*, 238 F. 2d 589 (3rd Cir., 1956).

[22] Following the *Automobile Club* case retroactive application of change of position has not been sustained for example in *City Loan Savings Co.* v. *United States*, 177 F. Supp. 843 (N. D. Ohio, 1959), affirmed 287 F. 2d 612 (6th Cir., 1961); *Schuster* v. *Commissioner*, 312 F. 2d 311 (9th Cir., 1962).

sion. This Memorandum had been published in 1943 and available to all, including the Automobile Club of Michigan, and ruled that clubs such as the Michigan Automobile Club were not entitled to exemption. The Automobile Club of Michigan therefore commencing in 1943 had been on notice that the Commissioner of Internal Revenue had changed his position to correct a mistake. There was no ground for complaint since the change of position was being applied only to years commencing in 1943 and years prior to 1943 were not affected.

On the other hand, in 1952 petitioners believed that discount under the 1939 Code was a capital and not an income item, and this belief was based upon the then position of the Government as evidenced by the Caulkins Acquiescence, which position had existed unchanged for many years. During that year purchase and sale of securities were made in reliance on that belief. There was no warning or statement available at that time to petitioners of a change of position. Subsequently, the Government did change its position and ruled that *Caulkins* was wrongly decided and the Acquiescence should therefore be withdrawn. The new position was then applied to transactions consumated in prior years in reliance on the prior position.

Knowledge of the Government's position and interpretations of the Internal Revenue Code is of course highly significant. However, this becomes meaningless if the Government not only can change its position and interpretations but retroactively apply these changes to transactions which had been consummated in reliance upon the prior position and interpretations.[23] Under such circum-

[23] In enacting Section 506 of the Revenue Act of 1934 the predecessor to Section 3791(b) of the 1939 Code, Congress made it clear that the purpose of this Section was to make available to the Government the power to avoid "inequitable results" which can exist when new interpretations are applied "to past transactions which have been closed by taxpayers in reliance upon existing practice * * *." (H. Rep. No. 74, 73rd Cong., 2d Sess., p. 38).

stances the Government attempt to ignore interpretations publicly accepted by it in 1952 as well as for many years prior thereto and to apply contrary interpretations first announced some time later should not be sustained but held to be an abuse of discretion within the contemplation of the decision in *Automobile Club of Michigan*.

C. The Government Should Not Be Permitted to Apply its Change of Position and Withdrawal of Acquiescence in a Manner Which Discriminates Against Petitioners.

The principle that one taxpayer cannot without logical justification be discriminated against in favor of another taxpayer is an integral part of the tax structure. In the words of Mr. Justice Frankfurter concurring in *United States* v. *Kaiser*, 363 U. S. 299, 308 (1960):

> "* * * The Commissioner cannot tax one and not tax another without some rational basis for the difference. And so, assuming the correctness of the principle of 'equality', it can be an independent ground of decision that the Commissioner has been inconsistent, without much concern for whether we should hold as an original matter that the position the Commissioner now seeks to sustain is wrong."

It is therefore not surprising that this Court in the *Automobile Club of Michigan* case stated that application to 1943 and 1944 of the 1945 revocation could be sustained because "circumstances" of the case showed that such change of position had been uniformly applied. The Automobile Club of Michigan had been treated no differently from any other club similarly situated. This Court recognized that if uniform treatment had not existed, discrimination would have resulted and there would have been a

"circumstance" evidencing abuse of the power allowed the Government in Section 3791(b) (353 U. S. at pp. 185-186).[24]

In the light of this Court's reasoning in the *Automobile Club of Michigan* case, the following facts of this case are most relevant: In 1955 the Government announced in Revenue Ruling 55-136 that the *Caulkins* case would no longer be followed, that this case and the Acquiescence therein were erroneous and that a change of position by the Government was necessitated. However, the possible injustice of applying the change of position against those who had relied on the Caulkins Acquiescence was apparently recognized. The 1955 ruling places in a special class those taxpayers who had made acquisitions of discount securities during the period between December 25, 1944 (the date of the Caulkins Acquiescence) and the date of issuance of the 1955 ruling.[25] However, this favored group does not include all purchasers of discount securities in this period but only those who had purchased a certain kind of security from a certain issuer, namely, Accumulative Installment Certificates from the Investors Syndicate. Accordingly, the Government has attempted to be selective and not uniform. Such an attempt cannot be condoned under *Automobile Club of Michigan*.

The difference in treatment might be acceptable if the discount in the securities here involved could be different from the discount in the securities sold by Investors Syndi-

[24] In *Brecklein* v. *Bookwalter*, 231 F. Supp. 404 (D. C. Mo. 1964) (appeal pending 8th Cir.) retroactive application of a change of position was not permitted against one taxpayer if not applied as against all taxpayers, and the *Automobile Club of Michigan* case is cited and quoted as "impliedly" supporting the Court's decision. See also *Exchange Parts Co. of Fort Worth* v. *United States*, 279 F. 2d 251 (Ct. Cl., 1960); *Connecticut Railway & Lighting Co.* v. *United States*, 142 F. Supp. 907 (Ct. Cl., 1956).

[25] In Revenue Ruling 56-299, 1956-1 Cum. Bull. 603 this period was shortened to December 31, 1954. It would appear that the reason for the modification is that Section 1232 of the 1954 Code expressly applies to obligations issued after December 31, 1954 and this provision of course makes of discount an income item.

cate. No such basis exists and this has been recognized by the Government. In the same Revenue Ruling 55-136 it is stated that "there is no logical basis in fact or in law to distinguish the discount element in the Accumulative Installment Certificates involved in the Caulkins case from the original discount element involved ordinarily in the issuance of any bonds." (1955-1 Cum. Bull. 213, 214).

As this Court has recognized, the power retroactively to apply a change of position must be properly exercised and cannot be abused. In view of the lack of uniform treatment, for which no justification can exist, there surely is an abuse of discretion under Section 3791(b) which should be corrected.

The Second Circuit to support its conclusion does refer to *Automobile Club of Michigan.* However, the Court apparently made no examination of the "circumstances of the case" since it concluded that retroactive correction is always permissible without regard to the circumstances (R. 49). This conclusion is not supported by the decision of this Court in *Automobile Club of Michigan.* On the contrary, this Court made it clear that retroactive application may constitute an abuse of discretion, and had the Court below followed the standards accepted by this Court, it should not have refused to recognize the validity of petitioners complaint. The "circumstances" emphasized by this Court as permitting retroactive application are not present here.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the judgment of the Court below should be reversed.

Respectfully submitted,

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APPENDIX

Internal Revenue Code of 1939

Sec. 42. Period in Which Items of Gross Income Included.

* * *

(b) Noninterest-Bearing Obligations Issued at Discount.—If, in the case of a taxpayer owning any noninterest-bearing obligation issued at a discount and redeemable for fixed amounts increasing at stated intervals or owning an obligation described in paragraph (2) of subsection (d), the increase in the redemption price of such obligation occurring in the taxable year does not (under the method of accounting used in computing his net income) constitute income to him in such year, such taxpayer may, at his election made in his return for any taxable year beginning after December 31, 1940, treat such increase as income received in such taxable year. If any such election is made with respect to any such obligation, it shall apply also to all such obligations owned by the taxpayer at the beginning of the first taxable year to which it applies and to all such obligations thereafter acquired by him and shall be binding for all subsequent taxable years, unless upon application by the taxpayer the Commissioner permits him, subject to such conditions as the Commissioner deems necessary, to change to a different method. In the case of any such obligations owned by the taxpayer at the beginning of the first taxable year to which his election applies, the increase in the redemption price of such obligations occurring between the date of acquisition (or, in the case of an obligation described in paragraph (2) of subsection (d), the date of acquisition of the series E bond involved) and the first day of such taxable year shall also be treated as income received in such taxable year.

(c) Short-Term Obligations Issued on Discount Basis.—In the case of any obligation of the United States or any of its possessions, or of a State or Territory, or any political

subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, the amount of discount at which such obligation is originally sold shall not be considered to accrue until the date on which such obligation is paid at maturity, sold, or otherwise disposed of.

* * *

(26 U. S. C. 1952 ed., Sec. 42)

Sec. 111. Determination of Amount of, and Recognition of, Gain or Loss.

(a) Computation of Gain or Loss.—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

* * *

(26 U. S. C. 1952 ed., Sec. 111)

Sec. 117. Capital Gains and Losses.

(a) Definitions.—As used in this chapter—

(1) Capital Assets.—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

* * *

(D) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

* * *

(2) Short-Term Capital Gain.—The term "short-term capital gain" means gain from the sale or exchange of a

capital asset held for not more than 6 months, if and to the extent such gain is taken into account in computing gross income;

* * *

(4) Long-Term Capital Gain.—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing net income;

(f) Retirement of Bonds, etc.—For the purposes of this chapter, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor.

* * *

(26 U. S. C. 1952 ed., Sec. 117)

Sec. 125. Amortizable Bond Premium.

(a) General rule. In the case of any bond, as defined in subsection (d), the following rules shall apply to the amortizable bond premium (determined under subsection (b)) on the bond for any taxable year beginning after December 31, 1941:

(1) Interest wholly or partially taxable. In the case of a bond (other than a bond the interest on which is excludible from gross income), the amount of the amortizable bond premium for the taxable year shall be allowed as a deduction.

(2) Interest wholly tax-exempt. In the case of any bond the interest on which is excludible from gross income, no deduction shall be allowed for the amortizable bond premium for the taxable year.

(3) Adjustment of credit in case of interest partially tax-exempt. In the case of any bond, the interest on which is allowable as a credit against net income, the credit pro-

vided in section 25(a)(1) or (2), or section 26(a), as the case may be, shall be reduced by the amount of the amortizable bond premium for the taxable year. (For adjustment to basis on account of amortizable bond premium see section 113(b)(1)(H).)

* * *

(c) Election on taxable and partially taxable bonds.

(1) Eligibility to elect and bonds with respect to which election permitted. This section shall apply with respect to the following classes of taxpayers with respect to the following classes of taxpayers with respect to the following classes of bonds only if the taxpayer has elected to have this section apply.

(A) Partially tax-exempt.—In the case of a taxpayer other than a corporation, bonds with respect to the interest on which the credit provided in section 25(a)(1) or (2) is allowable; and

(B) Wholly taxable.—In the case of any taxpayer, bonds the interest on which is not excludible from gross income but with respect to which the credit provided in section 25(a)(1) or (2), or section 26(a), as the case may be, is not allowable.

(2) Manner and effect of election.—The election authorized under this subsection shall be made in accordance with such regulations as the Commissioner with the approval of the Secretary shall prescribe. If such election is made with respect to any bond (described in paragraph (1)) of the taxpayer, it shall also apply to all such bonds held by the taxpayer at the beginning of the first taxable year to which the election applies and to all such bonds thereafter acquired by him and shall be binding for all subsequent taxable years with respect to all such bonds of the taxpayer, unless, upon application by the taxpayer, the Commissioner permits him, subject to such conditions as the Commissioner deems necessary, to revoke such elec-

tion. The election authorized under this subsection in the case of a member of a partnership shall be exercisable with respect to bonds of the partnership only by the partnership. In the case of bonds held by a common trust fund, as defined in section 169, or by a foreign personal holding company, as defined in section 331, the election authorized under this subsection shall be exercisable with respect to such bonds only by the common trust fund or foreign personal holding company.

* * *

(26 U. S. C. 1952 ed., Sec. 125)

Sec. 201. Life Insurance Companies.

* * *

(e) Amortization of premium and accrual of discount. The gross income, the deduction provided in section 201(c)(7)(A) and the credit allowed against net income in section 26(a) shall each be decreased by the appropriate amortization of premium and increased by the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures or other evidences of indebtedness held by a life insurance company. Such amortization and accrual shall be determined (1) in accordance with the method regularly employed by such company, if such method is reasonable, and (2) in all other cases in accordance with regulations prescribed by the Commissioner with the approval of the Secretary.

* * *

(26 U. S. C. 1952 ed., Sec. 201)

Sec. 207. Mutual Insurance Companies other than Life or Marine.

* * *

(d) Amortization of premium and Accrual of Discount. The gross amount of income during the taxable year from interest, the deduction provided in subsection (b)(4)(A), and the credit allowed against net income in section 26(a) shall each be decreased by the appropriate amortization

of premium and increased by the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures or other evidences of indebtedness held by a mutual insurance company subject to the tax imposed by this section. Such amortization and accrual shall be determined (1) in accordance with the method regularly employed by such company, if such method is reasonable, and (2) in all other cases, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary.

* * *

(26 U. S. C. 1952 ed., Sec. 207)

SEC. 3791. RULES AND REGULATIONS.

* * *

(b) RETROACTIVITY OF REGULATIONS OR RULINGS. The Secretary, or the Commissioner with the approval of the Secretary may prescribe the extent, if any, to which any ruling, regulation, or Treasury Decision, relating to the internal revenue laws, shall be applied without retroactive effect.

(26 U. S. C. 1952 ed., Sec. 3791)

Internal Revenue Code of 1954

Sec. 171. Amortizable Bond Premium.

(a) General Rule.—In the case of any bond, as defined in subsection (d), the following rules shall apply to the amortizable bond premium (determined under subsection (b)) on the bond:

(1) Interest wholly or partially taxable.—In the case of a bond (other than a bond the interest on which is excludable from gross income), the amount of the amortizable bond premium for the taxable year shall be allowed as a deduction.

(2) Interest wholly tax-exempt.—In the case of any bond the interest on which is excludable from gross income, no deduction shall be allowed for the amortizable bond premium for the taxable year.

(3) Adjustment of credit or deduction for interest partially tax exempt.—

(A) Individuals.—In the case of any bond the interest on which is allowable as a credit under section 35, the amount which would otherwise be taken into account in computing such credit shall be reduced by the amount of the amortizable bond premium for the taxable year.

(B) Corporation.—In the case of any bond the interest on which is allowable as a deduction under section 242, such deduction shall be reduced by the amount of the amortizable bond premium for the taxable year.

(4) Cross reference.—

For adjustment to basis on account of amortizable bond premium, see section 1016(a)(5).

* * * *

(c) Election as to Taxable and Partially Taxable Bonds.—

(1) Eligibility to elect; bonds with respect to which election permitted.—This section shall apply with respect to the following classes of taxpayers with respect to the following classes of bonds only if the taxpayer has elected to have this section apply:

(A) Partially tax-exempt.—In the case of a taxpayer other than a corporation, bonds with respect to the interest on which the credit provided in section 35 is allowable; and

(B) Wholly taxable.—In the case of any taxpayer, bonds the interest on which is not excludable

from gross income but with respect to which the credit provided in section 35, or the deduction provided in section 242, is not allowable.

(2) Manner and effect of election.—The election authorized under this subsection shall be made in accordance with such regulations as the Secretary or his delegate shall prescribe. If such election is made with respect to any bond (described in paragraph (1)) of the taxpayer, it shall also apply to all such bonds held by the taxpayer at the beginning of the first taxable year to which the election applies and to all such bonds thereafter acquired by him and shall be binding for all subsequent taxable years with respect to all such bonds of the taxpayer, unless, on application by the taxpayer, the Secretary or his delegate permits him, subject to such conditions as the Secretary or his delegate deems necessary, to revoke such election. In the case of bonds held by a common trust fund, as defined in section 584(a), or by a foreign personal holding company, as defined in section 552, the election authorized under this subsection shall be exercisable with respect to such bonds only by the common trust fund or foreign personal holding company. In case of bonds held by an estate or trust, the election authorized under this subsection shall be exercisable with respect to such bonds only by the fiduciary.

* * *

(26 U. S. C. 1958 ed., Sec. 171)

SEC. 483. INTEREST ON CERTAIN DEFERRED PAYMENTS.

(a) AMOUNT CONSTITUTING INTEREST.—For purposes of this title, in the case of any contract for the sale or exchange of property there shall be treated as interest that part of a payment to which this section applies which bears the same ratio to the amount of such payment as the total unstated interest under such contract bears to the total of the payments to which this section applies which are due under such contract.

(b) TOTAL UNSTATED INTEREST.—For purposes of this section, the term "total unstated interest" means, with respect to a contract for the sale or exchange of property, an amount equal to the excess of—

(1) the sum of the payments to which this section applies which are due under the contract, over

(2) the sum of the present values of such payments and the present values of any interest payments due under the contract.

For purposes of paragraph (2), the present value of a payment shall be determined, as of the date of the sale or exchange, by discounting such payment at the rate, and in the manner, provided in regulations prescribed by the Secretary or his delegate. Such regulations shall provide for discounting on the basis of 6-month brackets and shall provide that the present value of any interest payment due not more than 6 months after the date of the sale or exchange is an amount equal to 100 percent of such payment.

(c) PAYMENTS TO WHICH SECTION APPLIES—

(1) IN GENERAL.—Except as provided in subsection (f), this section shall apply to any payment on account of the sale or exchange of property which constitutes part or all of the sales price and which is due more than 6 months after the date of such sale or exchange under a contract—

(A) under which some or all of the payments are due more than one year after the date of such sale or exchange, and

(B) under which, using a rate provided by regulations prescribed by the Secretary or his delegate for purposes of this subparagraph, there is total unstated interest.

* * *

SEC. 1232. BONDS AND OTHER EVIDENCES OF INDEBTEDNESS.

(a) [as amended by Sec. 50 of the Technical Amendments Act of 1958, P. L. 85-866, 72 Stat. 1606] *General Rule.*—For purposes of this subtitle, in the case of bonds, debentures, notes, or certificates or other evidence of indebtedness, which are capital assets in the hands of the taxpayer, and which are issued by any corporation, or government or political subdivision thereof—

(1) *Retirement.*—Amounts received by the holder on retirement of such bonds or other evidences of indebtedness shall be considered as amounts received in exchange therefor (except that in the case of bonds or other evidences of indebtedness issued before January 1, 1955, this paragraph shall apply only to those issued with interest coupons or in registered form, or to those in such form on March 1, 1954).

(2) *Sale or Exchange.*—

(A) General rule.—Except as provided in subparagraph (B), upon sale or exchange of bonds or other evidences of indebtedness issued after December 31, 1954, held by the taxpayer more than 6 months, any gain realized which does not exceed—

(i) an amount equal to the original issue discount (as defined in subsection (b)), or

(ii) if at the time of original issue there was no intention to call the bond or other evidence of indebtedness before maturity, an amount which bears the same ratio to the original issue discount (as defined in subsection (b)) as the number of complete months that the bond or other evidence of indebtedness was held by the taxpayer bears to the number of complete months from the date of original issue to the date of maturity, shall be considered as gain from the sale or exchange of property which is not a capital asset. Gain in excess of such amount shall be con-

sidered gain from the sale or exchange of a capital asset held more than 6 months.

* * *

(b) Definitions—

(1) Original issue discount—For purposes of subsection (a), the term "original issue discount" means the difference between the issue price and the stated redemption price at maturity. If the original issue discount is less than one-fourth of 1 percent of the redemption price at maturity multiplied by the number of complete years to maturity, then the issue discount shall be considered to be zero. For purposes of this paragraph, the term "stated redemption price at maturity" means the amount fixed by the last modification of the purchase agreement and includes dividends payable at that time.

* * *

(26 U. S. C. 1958 ed., Sec. 1232)

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CITATIONS

766-948—65——1

Cases—Continued

In the Supreme Court of the United States

OCTOBER TERM, 1964

No. 486

W. BALMER DIXON, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the district court (R. 4–15) is reported at 224 F. Supp. 358. The opinion of the court of apepals (R. 44–49) is reported at 333 F. 2d 1016.

JURISDICTION

The judgment of the court of appeals was entered on June 19, 1964 (R. 50). The petition for writ of certiorari was filed on September 11, 1964, and was granted on December 14, 1964 (R. 51). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether the excess of the face amount of a note over the amount of money for which it was issued

represents income which an accrual-basis lender must accrue ratably as it is earned.

2. Whether the Commissioner was estopped to challenge the taxpayers' treatment of their gain from the sale of notes issued at a discount as capital gain because of a prior acquiescence in another case.

STATUTES AND REGULATIONS INVOLVED

The relevant statutes and regulations are set out in the Appendix to our brief in the companion case, *United States* v. *Midland-Ross Corp.*, No. 628.

STATEMENT

Petitioners are partners in the investment firm of Carl M. Loeb, Rhoades & Company. At various times during the taxable year 1952, the partnership purchased for its own account 33 short-term, non-interest bearing notes, either directly from the obligor corporation, or through agents or dealers. The notes bore maturity dates ranging from 190 to 272 days from the date of issue, and all were issued at discounts varying between 2⅜% and 3¾% of the face value. The total face amount of the notes was $43,050,000 and the amount for which they were issued was $42,222,357. Upon purchase the notes were pledged as collateral to secure bank loans in the full face amount of the notes (R. 28–29, 32).

During 1952, the partnership sold 20 of the notes, after holding them for more than six months, at a profit of $494,528. In the same year, it paid $624,000 in interest on the bank loans used to finance the purchase of the notes. The remaining 13 notes were not disposed of until the following year (R. 29).

In the partnership return for 1952, the $194,528 gain on the sale of the 20 notes was reported as long-term capital gain; no income was accrued on account of the 13 notes remaining on hand; and the $624,060 interest paid on the bank loans was deducted as an ordinary deduction. Petitioners reported their distributive shares of the partnership income in the same manner. The Commissioner determined that the excess of the face amount of the notes over the amount of money for which they were issued represented interest accruing over the term of the notes. Since the partnership was on the accrual basis, the interest accruing on all 33 of the notes during the period they were held by the partnership was determined to be includible in partnership income and hence in petitioners' distributive shares.[1] Petitioners paid the resulting deficiencies and in due course brought this suit for refund (R. 46). Both the district court (R. 4–15) and the court of appeals (R. 44–49) upheld the Commissioner's determination and denied the refunds.

ARGUMENT

INTRODUCTION AND SUMMARY

The transactions involved in this case are virtually identical to those involved in the companion case, *United States* v. *Midland-Ross Corp.*, No. 628, and the

[1] As the court of appeals noted (R. 47), "no question has been raised as to the propriety of taxing the individual partners for notes held by the partnership, and the taxpayers have conceded that if the discount *did* represent ordinary income, that income was realized upon each of the thirty-three notes held, and was not dependent upon a sale".

basic issue is the same. We showed in our brief in that case that the amount to be paid on maturity of a note in excess of the amount for which it was issued is equally "interest" paid for the use of money—and must be so taxed—whether it is labelled as such or is given no name. No purpose would be served by repeating that argument here, and we respectfully refer the Court to our brief in *Midland-Ross* for our principal argument on the issue common to the two cases. Our brief in this case will be confined (1) to answering petitioners' alternative argument that the Commissioner was estopped to assert the tax involved in this case because of his acquiescence in *Caulkins* v. *Commissioner* (an issue not raised in *Midland-Ross*) and (2) to responding to particular arguments made by respondents which warrant special comment.

With respect to the estoppel issue, we argue, first, that an acquiescence in an erroneous decision cannot bar the United States from collecting a tax otherwise lawfully due, and that petitioner cannot claim to have been misled in this regard, since each Cumulative Bulletin carries a prominent warning that rulings and acquiescences do not have any binding effect. We further show that, even if the Commissioner were committed to follow any decision in which he had acquiesced, the *Caulkins* decision in no event supports the treatment claimed by petitioners.

In the second part of our brief, we respond to petitioners' contentions based upon (a) the legislative history of the Act of June 17, 1929 (exempting interest on Treasury bills); (b) the 1938 report of a

subcommittee of the House Ways and Means Committee; (c) the alleged redundancy of certain special statutory provisions if bond discount were generally treated as interest; and (d) the treatment of bond premiums.

I

THE COMMISSIONER'S ACQUIESCENCE IN THE CAULKINS DECISION HAD NO LEGAL FORCE AND IS DISTINGUISHABLE IN ANY EVENT

Petitioners contend that the Commissioner was estopped to challenge their treatment of the note because he had previously announced,[2] and only later withdrew,[3] his "acquiescence" in *Caulkins* v. *Commissioner,* 1 T.C. 656, affirmed, 144 F. 2d 482 (C.A. 6). The argument is insubstantial for two reasons: (1) an acquiescence has no binding force; and (2) *Caulkins* is distinguishable in any event.

1. The power to prescribe how transactions will be taxed lies with Congress, not the Commissioner, and his rulings can have only such force as Congress chooses to give them. There being no statute giving acquiescences the force of law, an acquiescence in an erroneous decision cannot bar the United States from collecting a tax otherwise lawfully due:[4] "the doctrine

[2] 1944 Cum. Bull. 5.

[3] Rev. Rul. 119, 1953-2 Cum. Bull. 95; Rev. Bul. 55-136, 1955-1 Cum. Bull. 7, 213, republished as Rev. Rul. 56-299, 1956-1 1 Cum. Bull. 603.

[4] *Manhattan Co.* v. *Commissioner*, 297 U.S. 129; *Commissioner* v. *Acker*, 361 U.S. 87; *United States* v. *Calamaro*, 354 U.S. 351, 355-359; *Koshland* v. *Helvering*, 298 U.S. 441, 446-447; *Tomlinson* v. *Miles*, 316 F. 2d 710, 714 (C.A. 5), certiorari

of equitable estoppel is not a bar to the correction by the Commissioner of a mistake of law." [5]

Nor can petitioner claim to have been misled as to the effect of an acquiescence, for each Cumulative Bulletin carries a prominent warning to taxpayers that rulings and acquiescences do not have any binding effect. The 1944 Cumulative Bulletin, for example—the one in which the acquiescence in *Caulkins* was announced—stated on its front page that:

> The rulings reported in the Internal Revenue Bulletin are for the information of taxpayers and their counsel as showing the trend of official opinion in the administration of the Bureau of Internal Revenue; the rulings other than Treasury Decisions have none of the force or effect of Treasury Decisions and do not commit the Department to any interpretation of the law which has not been formally approved and promulgated by the Secretary of the Treasury. * * *

1944 Cum. Bul., p. i. See also *e.g.*, 1952–1 Cum. Bull., p. i; 1964–1 Cum. Bull. 3. In the face of that express disclaimer, there is no basis for a claim by petitioners that they relied on the acquiescence in *Caulkins* as a

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denied, 375 U.S. 828; *Carlton's Estate* v. *Commissioner*, 298 F. 2d 415, 419 (C.A. 2); *Cahen Trust* v. *United States*, 292 F. 2d 33, 39 (C.A. 7); *Lubin* v. *Commissioner*, decided October 24, 1963 (22 T.C.M. 1494), reversed on other grounds, 335 F. 2d 209 (C.A. 2); *Schwartz* v. *Commissioner*, 40 T.C. 191. See also Lynn and Gerson, *Quasi-Estoppel and Abuse of Discretion as Applied Against the United States in Federal Tax Controversies*, 19 Tax. L. Rev. 487, 512–516 (1964); 10 Mertens, *Law of Federal Income Taxation* (Rev. 1964), Section 60.16.

[5] *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, 183.

binding assurance that their hoped-for capital gains treatment would not be challenged. See *Helvering* v. *N.Y. Trust Co.,* 292 U.S. 455, 468.

Since an acquiescence does not itself have any statutorily-prescribed effect, the only way in which it can operate to relieve a taxpayer of a tax otherwise due is through the Commissioner's subsequent exercise of the power expressly given him by § 7805 of the 1954 Code (§ 3791(b) of the 1939 Code) to "prescribe the extent, if any, to which any ruling * * * shall be applied without retroactive effect." What limits, if any, there may be on the Commissioner's failure to exercise the power given him by § 7805 need not be considered in this case. Petitioners point to nothing that would distinguish this case from the revocation of any acquiescence, and their argument that it was an abuse of discretion for the Commissioner not to give the revocation only prospective effect amounts to an argument that revocations of acquiescences must always be given only prospective effect. That argument would convert the discretionary power given the Commissioner by § 7805 into a mandatory duty and thus wholly subvert the limited purpose of that provision.

2. Even if acquiescences did commit the United States to follow the decision acquiesced in, petitioners would still not be helped, for the *Caulkins* decision in no way supports the treatment claimed by them. The *Caulkins* case was analyzed in detail in our brief in *Midland-Ross* (pp. 25–31). As we there showed, the decision was based, not on a distinction between original issue discount and stated interest, but upon a reading of § 117(f) as specifically making all the pro-

ceeds of a *retirement* of certain kinds of evidences of indebtedness taxable only as capital gain whether or not some part of the proceeds constituted interest. Not only was the *Caulkins* decision on its face based specifically on § 117(f) (retirements), but in later cases the Tax Court itself [6] expressly distinguished sales and held that the portion of the proceeds of a sale attributable to original issue discount was taxable as ordinary income.[7] Since the notes in this case were sold rather than retired, neither § 117(f) nor, hence, the *Caulkins* decision has any application.

There is a further reason why *Caulkins* is even less relevant to this case than it was to *Midland-Ross*. In *Caulkins*, the taxable event was a retirement of the obligation, and in *Midland-Ross* the taxable event was treated as being the *sale* of the obligation. In this case, however, the partnership used the accrual method of accounting: what the Commissioner asserted, and both courts below held, was that the partnership was required to *accrue* the compensation for the use of its money which was earned during the year regardless of whether the note was sold (as 20 of them were) or was held beyond the end of the taxable year (as 13 of them were). The additional amount the borrowers agreed to pay on maturity of the notes was admittedly compensation for the use of petitioner's

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[6] In principle, the Commissioner's acquiescence was in the Tax Court's decision in the *Caulkins* case, not in the Sixth Circuit's decision affirming it.

[7] See *Paine* v. *Commissioner*, 23 T.C. 391, 401, reversed on other grounds, 236 F. 2d 398 (C.A. 8); *Shattuck* v. *Commissioner*, 25 T.C. 416, 423; *Stanton* v. *Commissioner*, 34 T.C. 1, 6. See, also, *Midland-Ross* Br. 29–31, n. 21.

money, and it was undeniably earned ratably over the term of the notes. Nothing more is required to establish the duty to accrue the compensation as it is earned. How the proceeds of a sale or retirement of such a note would be taxed to a cash-basis taxpayer who had not previously accrued the income is wholly beside the point.

The point just made may explain why petitioners have chosen persistently to misstate the issue in this case as being the treatment of "gain realized on the sale of notes issued at a discount" (Pet. Br. 2). As we had occasion to note in response to the same misstatement in the petition, that is not the issue. The issue is whether petitioners were required to accrue the discount as it was earned, (see §§ 41, 42(a)). The "sale or exchange" (§ 117(a)(4)) and "retirement" (§ 117(f)) provisions—and the confusion about their application created by *Caulkins*—simply have nothing whatever to do with that question.

II

THE AMOUNT PROMISED TO BE PAID ON A NOTE IN EXCESS OF THE AMOUNT FOR WHICH IT WAS ISSUED HAS HISTORICALLY BEEN TREATED AS INTEREST

The historical treatment of original-issue discount was developed in full in our brief in *Midland-Ross* (pp. 23–45) and need not be repeated here. A few additional comments are appropriate, however, to answer several specific contentions made by the petitioners in this case.

1. As noted in our *Midland-Ross* brief (pp. 34–35), the Act of June 17, 1929, 46 Stat. 19, 20, exempted

"interest" on Treasury bills from taxation and expressly provided that any discount at which such bills were issued "shall be considered to be interest" for purposes of the exemption. Petitioners quote two statements by Senators Couzens and Reed in the debates on that bill as showing a Congressional understanding that gain attributable to original-issue discount was generally treated as capital gain (Br. 14–15). When placed in their proper context, the statements do not have the significance attributed to them.

The bill initially proposed by the Treasury would have exempted not only the "interest" on Treasury bills but also "any gain from the sale or other disposition" of such bills, without distinguishing between gains attributable to the discount at which the bills were issued and gains attributable to fluctuations in their market value due to changes in the prevailing interest rate (71 Cong. Rec. 2328). Senator Couzens objected to that version of the bill specifically because it failed to make that distinction. He had no objection to the "interest" element, including discount, being exempted so that federal bonds would be exempt "to the same extent that State and municipal bonds are exempt" (p. 2329),[8] but saw no reason why a "capital gain" from such a bill (p. 2330)—which he later specifically identified as a gain attributable to market fluctuations (p. 2331)—should not be taxed. Senator Reed at first failed to recognize the distinction between the two kinds of gain, but then immedi-

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[8] For the treatment of original-issue discount on State bonds as exempt "interest," see pp. 33–36 of our *Midland-Ross* brief.

ately went on—in a statement not quoted by petitioners—to acknowledge the distinction and to agree that only the "interest" element should be exempt and that "capital gains" should continue to be taxed (p. 2331).[9] In view of the agreement thus reached that only "interest" and not "capital gains" should be exempt from tax, the bill was amended to delete the proposed exemption of any "gain from the sale or other disposition" of Treasury bills and to substitute the provision ultimately adopted making explicit the treatment of original-issue discount as interest.

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[9] The position of the several Senators is made plain in the following colloquy, in which the statement of Senator Reed quoted by petitioners is italicized (71 Cong. Rec. 2331):

> Mr. WALSH of Montana. I understand that perfectly well; but if I discount a bill for $100 at the bank, and I get only $96, I am paying 4 percent interest, or substantially 4 percent; and the difference between the $96 and the $100 is interest. It can not be designated in any other way, and that is the way it is understood. So when the Treasury discounts its bills at 4 percent, that 4 percent represents the interest which the Government pays.
>
> If the interest is exempt, as provided in the bill, and the principal is exempt, as provided in the bill, if the purchaser of the bill sells it meanwhile, and makes a profit on his sale, why should not that profit be taxable just the same as the profit he makes on the sale of stocks or anything else?
>
> Mr. COUZENS. Mr. President, if the Senator will yield to me, is not this a simple illustration? If the Government sells to you a $1,000 bond or certificate of indebtedness on a 4 percent basis, and you turn around and sall it on a 3 percent basis, the difference is profit.
>
> Mr. WALSH of Montana. Unquestionably.
>
> Mr. COUZENS. That is the simple way of putting it. In other words, if the Government sells the certificate to one individual on a 4 percent basis, and he turns around and

There is nothing in that history, we submit, to support petitioners' statement that the bill was originally opposed "because the Senate was of the opinion that discount when realized is capital gain and did not wish to set any precedent which would exempt any capital gain from tax" (Br. 14). The only feature of the bill which was opposed was its failure, as originally proposed, to distinguish between "interest" in

sells it on a 3 percent or 2 percent basis, the difference is profit.

Mr. WALSH of Montana. Exactly. I want 4 percent on my money, and I buy the bill; but I find some one who is perfectly content with 2½ percent, and he will offer me a premium for it.

Mr. REED. *Mr. President, it seems to me these questions have brought the issue down to the real point. What actually happens in the case of the transaction described by the Senator from Montana is that a negotiable instrument is bought at one price, and subsequently sold at another; and the profit, taken in connection with the time the bill is held, is a capital gain which is the equivalent of interest on that money.* [Emphasis supplied.]

Mr. COUZENS. Oh, no!

Mr. REED. It is just a matter of definition. Please indulge me until I finish the thought. Now, if we can agree that the amount of the discount at which the bill was originally sold shall be considered as interest, and that shall be nontaxable, while at the same time any transactions relating in capital gains pending the maturity of the certificate should be taxed, I think we should all be agreed on the situation. All the Treasury wants is to make that which is in good faith the equivalent of interest tax free, as it is today on Treasury certificates; and I understand that the Senator has no objection to that.

Mr. WALSH of Montana. Not at all. We are agreed about what ought to be done. It is simply a question as to the language in which our views ought to be expressed.

Mr. REED. It is merely a matter of expressing that thought clearly; and we ought to be able to agree on that.

the form of discount—which everyone agreed should be exempt—and "capital gain" attributable to market fluctuations—which everyone agreed should not be exempt. The only "precedent" which the Senate did not wish to set was that of exempting market fluctuation gains; the exemption of interest in the form of discount was already well established for State bonds and the only thing the Act as finally adopted did was to extend the same rule to federal bonds. The true significance of the 1929 Act is simply that it was the first of many examples of Congress' consistent recognition—each time it has had occasion to deal expressly with the question—that original-issue discount is interest and should be treated as such for tax purposes.

2. At pages 15–16 of their brief, petitioners quote at length from a 1938 report of a subcommittee of the Committee on Ways and Means in connection with a proposal (to eliminate the tax on capital gains) on which no further action was ever taken. From the very portion quoted, it is evident that the report was speaking only of *market* discount, which has indeed generally been treated as giving rise only to capital gains (see pp. 18–20 of our brief in *Midland-Ross*).

3. Petitioners list five provisions of the 1939 Code that allegedly would have been unnecessary if original-issue discount were generally treated as interest (Br. 17). The first three (§§ 117(a)(1)(D), 42(b), and 42(c)) were considered in our *Midland-Ross* brief (pp. 40–43) and, as there shown, their addition proves just the opposite. The remaining two, §§ 201(e) and 207(d), added by the Revenue Act of 1942,[10] require

[10] §§ 163 and 165, 56 Stat. 798.

life insurance companies and certain mutual insurance companies to accrue bond discount and to amortize bond premiums. Those provisions, it may be seen, served two very substantial purposes entirely apart from any question of the status of original-issue discount as interest: (1) they required such companies to treat *market* discounts or premiums as giving rise to ordinary income or deductions;[11] and (2) they required such items to be accounted for by accrual notwithstanding that life insurance companies were at the time generally required to report their income on the cash basis.[12]

4. Petitioners' reliance on the treatment of bond *premiums* (Br. 21–23) is equally misplaced. Most of the litigation over the treatment of bond premiums, and the statutory solution ultimately adopted, was concerned primarily with the treatment of bonds purchased on the market at a premium,[13] which poses a question analogous to the treatment of market discount rather than of original-issue discount.

The only case cited by petitioners which directly involved the treatment of bonds originally issued at a

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[11] See Treas. Regs. 111 (1939 Code), §§ 29.201–9, 29.207–6. The requirement that *market* discount be accrued by such companies was eliminated by the Revenue Act of 1964, § 228, 78 Stat. 19 (amending §§ 818(b) and 822(d)(2) of the 1954 Code). The purpose was to put such companies back on a par with other corporations in that respect, accounting for market discount as capital gain and for original-issue discount as ordinary income. See S. Rep. No. 830, 88th Cong., 2d Sess., pp. 122–124.

[12] See *Massachusetts Mutual Life Ins. Co.* v. *United States*, 288 U.S. 269; S. Rep. No. 1631, 77th Cong., 2d Sess., p. 147.

[13] See, *e.g.*, *New York Life Ins. Co.* v. *Edwards*, 271 U.S. 109 (Pet. Br. 21).

premium is *Old Colony R. Co.* v. *Commissioner*, 284 U.S. 552. The question there was whether a premium received by a corporation on the issuance of bonds prior to 1913 had to be reflected in its tax returns for subsequent years, either (a) under regulations characterizing such premium as income and requiring it to be amortized over the life of the bonds, or (b) as an offset to the stipulated interest paid to the bondholders and claimed by the corporation as a deduction. With respect to (a), the Court held that since the premium was received prior to the adoption of the Sixteenth Amendment, it could not be taxed as income in later years notwithstanding the amortization requirement—a requirement which the Court noted, however, "may properly be applied to premiums paid subsequent to March 1, 1913" (284 U.S. at 558).[14] As to (b), the Court held that the issuer could deduct the "nominal" interest payments in full even though economically they represented, in part, a repayment of the amount received for the bonds rather than compensation for the use of the lenders' money. The significance of the latter holding is questionable in view of the Court's explicit recognition that bond premiums received after 1913 must be amortized as income, since the effect of such treatment is precisely the same as if a pro rata share of the premium were subtracted from the "nominal" yearly interest

[14] The regulation has in fact been so applied. See, *e.g.*, *Bayshore Gardens, Inc.* v. *Commissioner*, 267 F. 2d 55 (C.A. 2); Treasury Regulations 111 (1939 Code), § 29.22(a)-17(2)(a); Treasury Regulations on Income Tax (1954 Code), § 1.161-12(c)(2) and (5).

in order to arrive at the true or "effective" interest. But even if the Court's rejection of the "effective interest" approach is taken at face value, it has little bearing on the present case. For, whatever the merits of that ruling, it soon became clear that its principle was limited to the treatment of premiums and was not to be extended to the treatment of discounts: in the case of bonds issued at a discount, the Court had no hesitation in holding that the issuer could deduct not only the "nominal" interest but also an amortized part of the amount to be paid on maturity in excess of the amount borrowed. *Helvering* v. *Union Pacific Co.*, 293 U.S. 282; *Old Mission Co.* v. *Helvering*, 293 U.S. 289; *Great Western Power Co.* v. *Commissioner*, 297 U.S. 543; *Western Maryland Ry. Co.* v. *Commissioner*, 33 F. 2d 695 (C.A. 4); *American Smelting & Refining Co.* v. *United States*, 130 F. 2d 883, 885 (C.A. 3). And if discount and premium are distinguishable for purposes of the issuer's accounting, they are equally distinguishable for purposes of the lender's accounting.

CONCLUSION

For the reasons stated above and in our brief in the companion case, *United States v. Midland-Ross Corp.*, No. 628, the judgment below should be affirmed.

Respectfully submitted.

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Supreme Court of the United States

October Term, 1964

No. 486

W. Palmer Dixon, Joan Dixon, Everett W. Cady, Clarissa H. Cady, J. Herbert Higgins, Marion Blair Higgins, Stephen A. Koshland, Carol F. Koshland, Henry A. Loeb, John L. Loeb, Carl M. Loeb, Jr., and Margaret L. Kempner, as Executors of the Last Will and Testament of Carl M. Loeb, Sr., Deceased, Henry A. Loeb, John L. Loeb, Carl M. Loeb, Jr., and Alan H. Kempner, as Executors of the Last Will and Testament of Adeline M. Loeb, Deceased, John L. Loeb, Frances L. Loeb, Henry A. Loeb, Louise S. Loeb, Clifford W. Michel, Barbara R. Michel, Mark J. Millard, Claire Millard, Henry Parish, 2nd, Dorothy Parish, Hubert R. A. Simon, Samuel L. Stedman and Gerda C. Stedman,

Petitioners,

against

The United States of America,

Respondent.

REPLY BRIEF FOR PETITIONER ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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Citations

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Respondent.

REPLY BRIEF FOR PETITIONER ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Introduction

The Government in its brief (Br. 4)* states that it has not repeated its principal argument on the issue common to this case and to the companion case of *United States* v. *Midland-Ross Corporation*, No. 628. This argument has already been answered by the brief for the taxpayer in

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* All "Br." references are to the Government's brief in this case.

that case. This reply brief will accordingly be confined to the Government's responses to petitioners' argument.

For convenience, since the Government has numbered as "I" its answer to petitioners' "Point II", we shall reply first to the Government's "I" and then to the Government's "II."

POINT I

Because of the circumstances of this case, the Government's retroactive and discriminatory application of its change of position as regards discount should not be upheld.

1. Petitioners do not maintain that all changes of position by the Government "must always be given only prospective effect" (Br. 7). It is petitioners' position based on *Automobile Club of Michigan* v. *Commissioner*, 353 U. S. 180 (1957) that *circumstances* can exist which make retroactive application of change of position an abuse of power.[1]

Retroactive application of a change of position was more clearly justified by the circumstances in *Automobile Club of Michigan*. Yet this Court found it necessary to examine the circumstances before it could uphold the Government's use of power. Nevertheless, in this case the Government arbitrarily argues (Br. 7) without authority that no such examination need now be made. No attempt is made to show that the retroactive change of position as regards issue discount was properly applied.

The examination of the circumstances in this case will show that the Government's change of position cannot be

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[1] *Schuster* v. *Commissioner*, 312 F. 2d 311 (9th Cir., 1962); *Lesavoy Foundation* v. *Commissioner*, 238 F. 2d 589 (3rd Cir., 1956); *Brecklein* v. *Bookwalter*, 231 F. Supp. 404 (D. C. Mo. 1964) (Appeal pending 8th Cir.).

upheld because (a) the change of position was retroactively applied without warning despite reliance on the prior position,[2] and (b) such retroactive application was not on a uniform basis and petitioners were discriminated against without reason.

2. The Government also argues that petitioners were not entitled to rely on the *Caulkins* Acquiescence [3] even if such reliance might otherwise bar retroactive application of a change of a position under the circumstances and in the manner here present (Br. 7). Two reasons are alleged.

(a) The Government argues, in *Caulkins* [4] the taxable event was a retirement, whereas here the taxable event was the accrual of the discount as required by the Government. And the Government maintains even *Midland-Ross* is closer to *Caulkins* because in *Midland-Ross* the taxable event was "treated" as being the sale of the debt obligation (Br. 8).

It is true that on audit of the Midland-Ross Corporation, an accrual basis taxpayer, the Government accepted the sale as the taxable event, whereas on audit of the partnership (in which petitioners were members), also an accrual basis entity, the Government required that the issue dis-

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[2] The Government cites (Br. 5, n. 4) as authority for its position in this case Lynn & Gerson, *Quasi-Estoppel and Abuse of Discretion as Applied Against the United States in Federal Tax Controversies*, 19 TAX L. REV. 487. In this same article it is pointed out (p. 509) that the Commissioner admitted in *Automobile Club of Michigan* that he may be deemed to have abused his discretion depending on the circumstances and that had the attempt been made to apply the change of position to years prior to 1943, the year in which the change of position was announced, taxpayer's contentions and cases cited in support might apply. In this case the change of position first indicated in 1953 and made final in 1955 is being applied to 1952.

[3] 1944 Cum. Bull. 5.

[4] *Caulkins* v. *Commissioner*, 1 T. C. 656, aff'd 144 F. 2d 482.

count be accrued.[5] This difference in audit treatment as between two accrual basis entities can have no relevance to the issue. It has been conceded that the securities in this case, as in *Midland-Ross* were sold prior to maturity in bona fide sales. The issue before the Court in both cases must therefore be the same. Moreover, as is pointed out in the brief for taxpayer in *Midland-Ross* (Br. 27-32) there is no basis for requiring accrual of discount.

The Government has in its argument about accrual assumed the conclusion to the issue before the Court (Br. 8-9). It cannot be that because the Government has erroneously required the accrual of discount on the ground that it was in the nature of interest, the issue here could be anything other than the status under the 1939 Code of discount when realized by sale or exchange. Surely, the Government cannot believe that the capital gain status of issue discount under the 1939 Code could conceivably depend on whether the taxpayer was on the cash or accrual basis. Gain attributable to capital appreciation is reportable by cash or accrual basis taxpayers alike only after realization by sale or other disposition. The Government's statement that petitioners are misstating the issue (Br. 9) is patently diversionary.

(b) The basic fallacy of the Government's interpretation of *Caulkins* and therefore its contention that the Acquiescence should not have been relied on (Br. 7-8) is developed in the brief for taxpayer in *Midland-Ross* (pp. 22-24). We need here make only two additional observations.

In the Revenue Ruling which withdrew the *Caulkins* Acquiescence retroactively except as to Accumulative In-

[5] In its brief in *Midland-Ross* (p. 3) and in its brief on petition for certiorari in this case (p. 7, n. 5), the Government admits that there could have been no basis for the distinction in treatment of the Midland-Ross Corporation but justifies the result on the ground that the difference in tax consequence had the Midland-Ross Corporation been treated in the same fashion as the partnership would have been "negligible."

stallment Certificates it is stated that there can be no basis for distinguishing the discount element and the tax treatment thereof in *Caulkins* from discount in any other obligation.[6] Accordingly, at all times the only issue concerned the status of issue discount.

Second, the Circuit Court in *Caulkins* pointed out that "because of the application of the capital gains tax to securities which on their retirement may not result in capital gain, inconsistencies and inequalities may well result from the application of Section 117(f)." 144 F. 2d at 484. The securities to which the Court referred were necessarily those (like the securities here involved) which were not in registered form or with interest coupons attached and which would therefore under the 1939 Code not be regarded as "exchanged" and therefore not eligible for capital gains treatment on their retirement. Since capital gains treatment could be applicable only if such securities were sold, the Court clearly recognized that sale before retirement of discount securities resulted in capital gains treatment and its decision therefore was not confined to the situation where discount was realized on retirement pursuant to Section 117(f).

The issue in *Caulkins* was accordingly identical with the issue in this case. Therefore, petitioners were privileged to rely upon the *Caulkins* Acquiescence in view of the identity of issue. Such reliance was invited by the statement in the Cumulative Bulletin quoted in petitioners' brief (p. 30).[7]

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[6] Rev. Rul. 55-136, 1955-1 Cum. Bull. 213, 214.

[7] The Government quotes from the introduction to the Cumulative Bulletin in 1944 to show "an express disclaimer" and therefore no basis for a claim of reliance (Br. 7). The Government neglects to quote the separate and special statement (quoted by petitioners) which is confined to Acquiescences and which appears in both the 1944 and 1952 Cumulative Bulletins.

POINT II

Analysis of legislative history and precedent in this Court supports petitioners' contention that prior to the 1954 Code original issue discount on private securities was a capital item.

1. The 1929 Senate Debate in connection with an amendment to the Second Liberty Bond Act supports petitioners' construction of the 1939 Code.[8] The debate and the legislation which followed showed that the Senate accepted the tax status of issue discount as capital gain despite its relationship to compensation for the use of money and found it necessary specifically to characterize the issue discount on the newly-authorized Treasury Bills as "interest" in order to make applicable the tax exemption for "interest."

The debate is reproduced in detail in the appendix to taxpayer's brief in *Midland-Ross* (pp. 11a-33a).[9] For the convenience of the Court references to debate hereafter set forth are to the appropriate pages of that appendix rather than to the Congressional Record.[10]

The debate evidences the following:

(a) The amendment authorized the issue of Certificates of Indebtedness at not less than par and to carry interest

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[8] The only Court which in considering the issue analyzed the 1929 Debate was the District Court in *Midland-Ross* (214 F. Supp. 631). Judge Kalbfleisch (214 F. Supp. at 637) found the demonstrated Congressional understanding of discount as a capital item and the need for legislation to provide otherwise most persuasive.

[9] The more relevant portions of the debate are found in pages 20a-33a.

[10] Several senators participated in the debate. However, those whose statements bear the closest reading are Senators Smoot, Couzens and Reed. They were the only members of the Senate Finance Committee to participate and displayed the most understanding of the then tax law and practice.

and Treasury Bills to be issued on a discount basis and without interest (p. 12a). In Section (b) of the amendment it was provided that all such Certificates and Bills shall be exempt both as to principal and interest and that any gain from the sale or other disposition thereof shall be exempt from tax (p. 13a). Since the Certificates and not the Bills were to be issued with interest, the exemption for interest could apply only to the Certificates. The provision with regard to gain on sale was designed for the Bills since the discount at which they were being issued would inevitably result in a gain on sale.[11]

(b) It was acknowledged that for the Bills to be saleable it would be desirable to provide tax exemption comparable to that being concurrently continued for interest. The Treasury had proposed, and the Senate Finance Committee had accepted capital gains tax exemption for the Bills as their solution for the problem of providing the tax exemption.[12]

(c) The Senate realized that the provisions of the statute exempting from tax interest on United States obli-

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[11] Senator Reed (28a):

"It is to prevent that discount being taxable that the words were inserted on page 3 which the Senator from Michigan is now trying to strike out."

[12] Senator Smoot (16a):

"The Senator will admit, will he not, that if the bills were exempt so far as capital-gains taxation is concerned, the Government could purchase the money through these bills a little cheaper than it otherwise could?"

Senator Smoot (17a):

". . . They [the Bills] will be sold in the open market, as I have already stated, and the Treasury Department thinks at least—and I rather agree with them—that with this provision in the bill they may be able to obtain money for the short periods of time desired at a little less rate and perhaps make more than would be gained by taxing capital gains which might accrue upon the bills."

gations would not protect as against tax the realization of the discount at which the Bills would be issued.[13] The Senate based this conclusion upon its understanding that under existing law issue discount realized on sale was taxable as capital gain and not as interest—and it is clear that the Treasury was in accord.[14] Since discount was not "interest" it would not be exempt from tax without specific legislation.

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[13] Senator Smoot (30a):

"Mr. President, the theory of the bill is that if the bills are tax exempt, the Government of the United States can make more out of their sale because of a lesser rate of interest than it can by taxing capital gain if a profit should be made. No interest is involved in it at all; there is no interest to be collecte on the bills; they are sold without interest; and the Secretar of the Treasury believes that with the words which have been referred to in the bill the Government will get more for the securities than if it imposed a tax upon whatever the interest might be."

[14] Senator Couzens (25a-26a):

"Mr. President, I wish to answer the Senator from Pennsylvania [Mr. Reed]. He is a very plausible debater, and what he says is substantially correct, except that to eliminate this provision would not defeat the purposes of the Treasury Department. All of the advantages that the Treasury Department would get under this proposed law will still be retained, even with the amendment which I propose, except a possible slight difference in the interest rate because of the fact that the banks may have to pay on the capital gain but that is all problematical. The Undersecretary of the Treasury stated before the Finance Committee that the same identical bills of indebtedness, when traded in commerce, are subject to a profit tax. When a bill is traded in commerce, an acceptance, or what not, if there is a capital gain, it is taxed. There is no difference whatever. Whether or not we take the money out of one pocket and put it into the other, the fact is that if we shall adopt the principle of exempting securities from the capital-gain tax we shall establish a principle which will return to plague us so long as we have the capital-gain tax on the statute books."

Senator Smoot (30a) note 13, *supra*.

This result was accepted with full awareness of the relationship between discount and compensation for the use of money and that in business thinking the discount was similar to interest.[15] When Senator Walsh of Montana

[15] Senator Reed (23a):

"... There is an apparent capital gain when a bank buys a 30-day note at a discount, but actually that capital gain represents the hire of the money for the interval that elapses between the purchase and the maturity date."

Senator Reed (24a):

"Precisely; and there the Senator puts his finger on the difference. If there is a capital gain in a transaction involving a 4¼% per cent Liberty bond, that is a true capital gain, and it is not interest. The coupon represents the interest on that investment. These certificates are to have no coupons, and ordinarily the capital gain in the five or six weeks that they would be held would represent the interest. It is the hire for the use of the money."

Senator Reed (24a-25a):

"... This would be the practical effect of the amendment: I personally do not care a rap whether the tax-exempt feature remains in the bill or not; but if we are going to make interest on Treasury certificates tax exempt—and that is what we have [p. 2330] done, because no corporation pays a penny of tax on certificate coupons—then there is no sense in providing for Treasury bills at all. If a corporation knows that it is going to have to pay a tax on the amount of the discount at which it purchases the Treasury bills under par—whether we regard it as a capital gain, as my friend from Michigan does, or whether we regard it as the hire of the money, as I do, does not make a particle of difference—no bank is going to buy Treasury bills on the same interest basis on which it will buy Treasury certificates, because one is free from tax and the other is subject to 11 per cent tax on all that gain. So there would be no use of initiating the system of Treasury bills if we are going to tax the fractional appreciation in the value. Banks will not buy them or else they will buy them at a discount, which is that much greater, so as to take care of the tax. We are just beating the devil around the bush if we try to make that fraction taxable because we have to pay it to the bank, and then we go and tax the bank and get it back to ourselves. We had better get the advantage of the lower discount rate."

suggested that the discount might be regarded like interest and the exemption for interest might apply because in the words of Senator Reed it represented "hire of the money" (p. 25a), Senator Reed replied (p. 29a): "That is the business way of doing it; *but under the present regulations of the Bureau of Internal Revenue the whole amount would be considered to be capital gain.*" (Emphasis added.)

(d) The objectors, led by Senator Couzens, were against any exemption from capital gains tax on the ground that an undesirable principle would thereby be established which might lead to exemption from tax of all capital gains.[16] Another solution to the problem became indicated.

(e) Discussion between Senator Couzens and Senator Reed developed the relationship of issue discount to compensation for the use of money despite the taxation thereof as a capital gain.[17] Since capital gains on other U. S. securities were subject to tax, there was reason to conclude that only the issue discount need be exempted from tax to make the Bills saleable.[18] It then became apparent that

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[16] Senator Couzens (22a):

"If that entering wedge is permitted to become effective to exempt any form of security from capital-gains tax, every Senator knows that it will be used as an argument by every agency that desires a repeal of the capital-gain tax."

[17] Senator Reed (23a):

". . . There is an apparent capital gain when a bank buys a 30-day note at a discount, but actually that capital gain represents the hire of the money for the interval that elapses between the purchase and the maturity date."

Senator Couzens (24a):

"I say the statement [Senator Reed (24a) note 15, *supra*] is misleading because it is not all interest. It depends upon the time that elapses between the issuance of the security and the date of maturity."

[18] Senator Couzens (24a):

"We are not discussing interest. We are discussing capital gain. The inference goes out that the bonds are not taxable in the hands of corporations. I contend that if there is a capital gain, they are taxable in the hands of a corporation."

the problem could be handled by making the discount which could always be identified, exempt from tax through labeling it "interest." [19] The suggested exemption from capital

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"Before the Senator proceeds further, I want to correct him in one respect. The Senator creates the impression that there can be no capital gain because it is all interest. If I buy one of those bills due September 1, 1929, and I buy it at 98 and sell it to-morrow at 99, there is a capital gain not represented by the interest to which the Senator has referred."

Senator Reed (24a).

"Of course there is"

Senator Couzens (31a):

"That is the simple way of putting it. In other words, if the Government sells the certificate to one individual on a 4 per cent basis, and he turns around and sells it on a 3 per cent or 2 per cent basis, the difference is profit."

[19] Senator Reed (31a):

"Mr. Reed. Mr. President, it seems to me these questions have brought the issue down to the real point. What actually happens in the case of the transaction described by the Senator from Montana is that a negotiable instrument is bought at one price, and subsequently sold at another; and the profit, taken in connection with the time the bill is held, is a capital gain which is the equivalent of interest on that money.

Mr. Couzens. Oh, no!

Mr. Reed. It is just a matter of definition. Please indulge me until I finish the thought. Now, if we can agree that the amount of the discount at which the bill was originally sold shall be considered as interest, and that that shall be nontaxable, while at the same time any transactions relating in capital gains pending the maturity of the certificate should be taxed, I think we should all be agreed on the situation. *All the Treasury wants is to make that which is in good faith the equivalent of interest tax free, as it is to-day on Treasury certificates*; and I understand that the Senator has no objection to that.

Mr. Walsh of Montana. Not at all. We are agreed about what ought to be done. It is simply a question as to the language in which our views ought to be expressed.

Mr. Reed. It is merely a matter of expressing that thought clearly; and we ought to be able to agree on that." (emphasis added)

gains tax was removed and there was substituted a provision which characterized the issue discount on the Bills as "interest"[20] Since interest on United States obligations was under the statute exempt from tax, the objective of the Treasury and of the Congress was achieved. This provision became Section 754(b) of 31 U. S. C.

It is clear, therefore, that to the Congress and to the Treasury absent special legislation issue discount when realized on a sale resulted in a capital gain and not interest. When Congress desired to separate issue discount from other profit and to classify the issue discount as "interest" because of its relationship to the use of money, it was fully aware of the avenues open to it and of its ability to prescribe the desired tax results by classifying the issue discount as interest as it did in 1929. For reasons best known to Congress it did not see fit prior to 1954 to characterize all issue discount as other than capital gain.

2. There is nothing in the 1938 report of a Subcommittee of the Committee on Ways and Means to support the Government's contention that the statement in the report that discount when realized on sale produces a capital gain referred only to "market discount" (Br. 13). In fact, the report (Pet. Br. pp. 15-16) demonstrates the contrary.

If Congress had in mind only market discount (as the Government claims, though this is nowhere to be seen), there would have been no need for the Committee to have

[20] Senator Couzens (32a):

"It leaves out all reference to capital gains, so that if a security sold by the United States is held to maturity, the gain is considered as interest, and is, therefore, under the law, tax exempt, but if there is any transaction in the particular note or security afterwards in which the interest rate changes, or in which there is a gain, that gain is taxable under the existing law. To offset that, we had to eliminate from the bill reference to the deduction of losses."

stated that "the complete exemption of capital gains from income taxes might well stimulate the conversion of other types of income into the form of capital gains."[21] If the intention ever existed in connection with a debt obligation to convert what might have otherwise been ordinary income into capital gain that intention could exist only at the time when the obligation was issued. Once issued, its terms could not be varied to create discount and the "conversion of other types of income into the form of capital gains" to which the proposed exemption from tax would apply.

3. The Government's discussion of Sections 201(e) and 207(d) admits that these sections are examples of specific legislation which characterizes discount as income, which enactments should have been superfluous if the general rule was, as contended by the Government, that issue discount always was income under the 1939 code.

Section 201(e) and Section 207(d) were added by the Revenue Act of 1942. Legislative history shows that as enacted by the House of Representatives they pertained only to bond premium and that the purpose thereof was to provide for insurance companies the right to amortize bond premium in the same manner as other holders of debt obligations who were then being permitted to amortize premium under Section 125, also added to the 1939 Code by the 1942 Revenue Act.[22]

The Senate broadened the scope of the provision by adding the requirement for accrual of discount as well; since premium was being allowed by statute as an offset to income, discount was being required by statute to be an increase to income.[23]

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[21] Report of Subcommittee of Committee on Ways and Means, 75th Cong. 3rd Sess. Dated Jan. 14, 1938. Reported in Hearings on H. R. 9682, 75th Cong. 3rd Sess., p. 38.

[22] H. Rep. No. 2333, 77th Cong., 2d Sess., p. 111.

[23] S. Rep. No. 1631, 77th Cong., 2d Sess., p. 147.

Thus Congress again demonstrated its awareness of discount and the need for specific legislation to make of it an income item *as well as the relationship between premium and discount.* However, although the Senate apparently believed that both premium and discount should in certain circumstances be placed on the same basis, it acted only with respect to certain insurance companies and not all taxpayers.

4. As was true of the Court below, the Government has not reconciled, because it could not, the adjudicated status of debt premium with its present position as regards debt discount. The Government would ignore the identity between premium and discount on the alleged ground that discount and premium have been distinguished for purposes of the issuer's accounting and ought therefore be distinguishable for the purposes of holder's accounting (Br. 16). None of the cases cited nor any of the materials brought forward support this distinction.[24]

Except where there were constitutional considerations because the premium was received prior to March 1, 1913, as in *Old Colony R. Co.* v. *Commissioner*, 284 U. S. 552, the Courts have given the same effect in the computation of the taxable income of the issuer to debt premium as they have to debt discount.[25] On an amortized basis the premium serves to increase the issuer's taxable income, whereas the discount serves to decrease taxable income. As regards the

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[24] Even Government rulings are to the contrary. G. C. M. 1455, 1927-1 Cum. Bull. 87, 88 ruled that "the treatment of premium is analagous to that of discount and therefore the Bureau rulings on the treatment of discount are in point." See also O. D. 475, 2 Cum. Bull. 211 (1920) which besides recognizing the correlation between discount and premium as regards the issuer and the amortization which was then required for both, states that such amortization "is not permissible in the case of the purchaser of bonds."

[25] The Government has agreed (Br. 15).

holder, this Court[26] and the Treasury have held that premium (even though effective to increase the issuer's taxable income) does not reduce the holder's taxable income unless there is special legislation.[27]

The principles applicable to a holder at a premium should be equally applicable to a holder at a discount. So long as in the absence of special legislation premium affects only capital gain or loss, so too can discount affect only capital gain or loss.

The Government does recognize that in *Old Colony R. Co.* this Court rejected the "effective interest approach." The Government's apparent reservations about "the merits of that ruling" (Br. 16) are beside the point.[28] The fact is that as regards premium, this Court (as well as the Government) has thus ruled that determination of taxable income is not controlled by business or economic concepts of what constitutes "compensation for the use of money." Such concepts are equally inconclusive when the tax question involves issue discount.

Legislative history shows that in 1942 express legislation was adopted to make of premium an income item to the holder by providing that he need only report the effec-

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[26] *New York Life Insurance Co.* v. *Edwards*, 271 U. S. 109. Contrary to the Government's contention (Br. 14), the record in that case does not in any way disclose that only bonds purchased at a market premium were involved.

[27] 4 Mertens, Law of Federal Income Taxation, Sec. 23.162, p. 296.

[28] In *Lubin* v. *Commissioner*, 335 F. 2d 209 (2d Cir. 1964), the Second Circuit refused to accept the contention that the gain realized on retirement of certain registered instruments was under the facts of that case taxable as interest and not as capital gain and rejected the Government's effective interest rate argument on the authority of *Old Colony R. Co.*

tive net yield as income from an obligation.[29] In 1954 Congress enacted Section 1232 and likewise made of issue discount an item of income by providing that when realized it is to be taxed as gain from the sale or exchange of a non-capital asset. However, the changed statute as regards discount was not in effect in 1952 since Section 1232 of the 1954 Code is expressly applicable only to debt obligations issued after December 31, 1954.[30]

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the judgment of the Court below should be reversed.

Respectfully submitted,

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[29] Section 125 which permitted premium amortization was added to the 1939 Code by the Revenue Bill of 1942. The Report of the House Ways and Means Committee states: "Under existing law, bond premium is treated as capital loss sustained by the owner of the bond at the time of disposition or maturity and periodical payments on the bond at the nominal or coupon rate are treated in full as interest. The want of statutory recognition of the sound accounting practice of amortizing premium leads to incorrect tax results which in many instances are so serious that provision should be made for their avoidance." H. Rep. No. 2333, 77th Cong., 2d Sess., p. 47.

[30] So far as can be ascertained, the Treasury did not prior to 1954 ask Congress to change the tax status of *all* issue discount. Under such circumstances, there is even more pertinence in the admonition of this Court in *Hanover Bank* v. *Commissioner*, 369 U. S. 672 at 682, that arguments which might have brought about a change in the statute cannot be the basis for supporting a Government interpretation of the existing statute which is not consistent with the meaning of the words used by Congress in the light of legislative history.